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No. 415

In the Supreme Court of the United States

OCTOBER TERM, 1970

UNITED STATES OF AMERICA, PETITIONER

v.

WATERMAN, LARGEN & CO., INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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v.

WATERMAN, LARGEN & CO., INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Claims in this case.

OPINIONS BELOW

The majority and dissenting opinions and the findings of fact and conclusion of law of the Court of Claims (Appendix A, *infra*, pp. 23–67) are reported at 419 F. 2d 845.

JURISDICTION

The judgment of the Court of Claims was entered on March 6, 1970 (Appendix B, *infra*, p. 69). By orders dated May 25, 1970, and June 24, 1970, the Chief Justice extended the time for filing a petition

for a writ of certiorari to and including August 3, 1970. The jurisdiction of this court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Whether a yarn mill broker's loss on its sale of corporate stock in a client mill manufacturer, acquired to regain the account of the manufacturer, is a loss on the sale of a capital asset defined in Section 1221 of the Internal Revenue Code.

STATUTE INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) a taxpayer whose personal efforts

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

STATEMENT

Respondent is a corporation engaged in the business of selling, on commission, various types of wool yarn produced by mills with which it has brokerage accounts. It was incorporated in May, 1958, as Waterman, Merrill, Largen & Co., Inc., upon the merging of the business interests of its three principals, Waterman, Merrill, and Largen. (Appendix A, *infra*, pp. 26, 53–54.)

The largest account that Merrill brought to the new corporation was Elmvale Worsted Company ("Elmvale"), a Massachusetts worsted wool producer. At the time of respondent's formation, Elmvale was in serious financial trouble and, by December, 1958,

having been unsuccessful in reversing consistent business losses, Elmvale decided to terminate its manufacturing operations. (Appendix A, *infra*, pp. 26–27, 54–55.)

This was a serious blow to respondent, which was itself experiencing financial difficulty. Elmvale was its third largest account, generating commissions of more than $2,000 a month, and its only substantial worsted wool account. A principal reason for respondent's organization had been the expectation of operating a worsted wool division. (Appendix A, *infra*, pp. 28, 54–55.)

Merrill attempted to replace Elmvale with another worsted wool account but was unable to do so. He entered into negotiations with Elmvale's president and principal stockholder, Carey Kinney, to see whether Elmvale's business might be carried on more successfully in another area. Kinney was receptive to this idea, and shortly thereafter a mill producing the same products as Elmvale was found in Laurens, South Carolina. Negotiations then began to form a new corporation to purchase the South Carolina mill. (Appendix A, *infra*, pp. 28–29, 56.)

Kinney was willing to permit respondent to become the new corporation's exclusive sales agent for all production—not merely worsted wool—on the condition that respondent purchase $100,000 of the new corporation's capital stock. It was his view that if a broker had a financial stake in a mill, the operation

do a more effective selling job. (Appendix A, *infra*, pp. 30, 57–58.)

Faced with the prospective loss of its major client producing worsted wool, which would have resulted in the dissolution of its worsted wool division, and given the opportunity of earning commissions of approximately $60,000 a year in the future by serving as broker for the new corporation's entire line, respondent determined that it would purchase stock in the new corporation. Neither respondent nor its principals had sufficient funds for this purpose, but respondent was able to borrow the money from Elmvale's factor, with the stock pledged as security for respondent's note. (Appendix A, *infra*, pp. 31, 60–61.)

The new corporation was named Elmvale Worsted Company, Inc. ("Elmvale-Laurens"). It began operations on June 8, 1959, after acquiring the assets of the old Laurens plant. Brud Kinney, Carey Kinney's son, became president, and the senior Kinney became chairman of the board of directors. The shareholders of Elmvale-Laurens, in addition to respondent (1,000 shares) and the Kinneys (1,350 shares), were Elmvale's raw material supplier (500 shares) and former shareholders of the old Laurens corporation (150 shares). (Appendix A, *infra*, pp. 60–61.)

Elmvale-Laurens' operations were unsuccessful from the beginning. As a result, respondent's commissions fell far below expectations, and adjustments had to be

addition, friction developed between Brad Kinney and respondent's selling personnel. By February, 1961, the situation had deteriorated to such an extent that Merrill concluded that he could no longer sell the Elmvale Lantrens yarn for respondent. He resigned as an employee, his stock in respondent was redeemed, and respondent's name was changed to its present form. Conditions continued to worsen, however, and on June 22, 1961, Brad Kinney wrote to respondent, terminating its agency effective June 30, 1961. On July 21, 1961, respondent sold its stock in Elmvale Lantrens for $25,000, thus suffering a loss of $75,000. (Appendix A, *infra*, pp. 31-32, 62-65.)

In its federal income return for 1961, respondent treated the loss as a capital loss. In 1963, it filed claims for refund, treating the loss as an ordinary loss which resulted in a net operating loss carryover to 1962. These claims were not allowed and respondent thereafter brought this suit for refund. (Appendix A, *infra*, pp. 65-66.) The Trial Commissioner determined that because respondent purchased the Elmvale Lantrens stock for a business purpose—to avoid the loss of a significant mill account, which would have had a serious adverse effect on its business—rather than with a view to obtaining dividends or capital appreciation, the stock was not a capital asset in respondent's hands. He accordingly held that the loss on the sale was an ordinary loss. The full court adopted the Trial Commissioner's opinion, findings, and recommended conclusion of law. Judges Davis

REASONS FOR GRANTING THE WRIT

This case and *Steadman* v. *Commissioner*, 424 F. 2d 1 (C.A. 6), involving the same basic question,[1] raise a pervasive issue of great importance. The question of statutory interpretation presented—whether corporate stock purchased for a business purpose constitutes a "capital asset" within the meaning of Section 1221—is a fundamental one, and the issue is one which constantly recurs in the administration of the revenue laws.

The decision below and that of the Sixth Circuit in *Steadman*, in which we are contemporaneously filing a petition for a writ of certiorari, are the culmination of a series of decisions in which the lower courts have significantly eroded the concept of a capital asset through misinterpretation of this Court's decision in *Corn Products Co.* v. *Commissioner*, 350 U.S. 46. The lower courts' interpretations of *Corn Products* have not been uniform. They are, in many instances, inconsistent with one another, and, we believe, contrary to the language and purpose of the capital asset provisions. This Court should clarify *Corn Products* to eliminate confusion in this basic area of the tax law, and to close a loophole through which taxpayers may obtain capital gains treatment on a profitable sale of corporate securities and ordinary loss on an unprofitable sale.

[1] The question in *Steadman* is whether an attorney who purchases stock in a corporate client, in order to retain the corporation as a client, may treat his loss on the subsequent worthlessness of the stock as an ordinary, rather than a capital, loss.

1. Section 1221 of the Code defines a "capital asset" to include "property held by the taxpayer," with the exception of five excluded categories of property. Capital stock does not fall within the excluded categories. Moreover, a number of other Code provisions explicitly call for ordinary gain or loss treatment on certain stock transactions, thus confirming what is implicit in Section 1221—that capital stock is a capital asset except in very special situations.

The question presented here is, in substance, the extent to which a "business purpose" attending the acquisition and holding of capital stock is to be considered in determining whether or not the stock constitutes a capital asset. Our position is that stock constitutes a capital asset for the purpose of Section 1221 whenever a taxpayer places its capital at the risk of a business for an indefinite future period, and that no showing of business purpose for the acquisition or holding of stock can operate to change that characterization.

2. The language of Section 1221 itself precludes a contrary interpretation of the statute. First, it provides, with specified exceptions, that a capital asset is property held by a taxpayer "*whether or not* connected with his trade or business" (emphasis added). There is thus no more reason for according noncapital treatment to capital stock acquired to insure a source of business income than that acquired to insure a source of nonbusiness (dividend) income. Second, Section 1221 (1), (2) and (4) excludes from the

Sections 165(g)(3), 341, 582, 1212, 1213, 1241, 1246 and 1248.

definition of capital assets certain property acquired, held, or used in the taxpayer's trade or business. But these exceptions are not (except in the case of dealers) applicable to corporate stock that is acquired, held, or used for business purposes.

Despite this language, the court below held that respondent's stock in Elmvale-Laureus was not a capital asset because it was purchased for a business purpose. In so holding, the court relied on this Court's decision in *Corn Products Co.* v. *Commissioner*, *supra*, which involved Section 117(a) of the Internal Revenue Code of 1939 (the predecessor of Section 1221 of the 1954 Code). The taxpayer in *Corn Products*, a manufacturer of corn products, adopted the practice of regularly purchasing corn futures to be delivered in 11 months or less after the contract, to guard against price increases in the raw material it used in its everyday business operations. On some occasions it took up the corn under the futures, and on others it sold the futures at a gain or loss. In holding that the futures were not capital assets in the taxpayer's hands, this Court stated (350 U.S. at pp. 51–52):

> Admittedly, petitioner's corn futures do not come within the literal language of the exclusions set out in * * * [Section 117]. They were not stock in trade, actual inventory, property held for sale to customers or depreciable property used in a trade or business. But the capital-asset provision of § 117 must not be so broadly applied as to defeat rather than further the purpose of Congress. *Burnet* v. *Harmel*, 287 U.S. 103, 108. Congress intended that profits and losses arising from the everyday

> operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income. It was intended "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." *Burnet v. Harmel*, 289 U.S., at 106. Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic congressional purpose. This Court has always construed narrowly the term "capital assets" in § 117. * * *

In *Booth Newspapers, Inc. v. United States*, 157 Ct. Cl. 886, 303 F. 2d 916, 920, the Court of Claims interpreted *Corn Products* as establishing an "elastic concept" of the term "capital asset," permitting assets literally described as capital assets in Section 1221 to be treated as noncapital assets in certain circumstances. However elastic the capital asset concept may be, it cannot be stretched so thin as to exclude corporate stock merely because it is acquired for a purpose related to the taxpayer's business. The question of the status of the Elmvale-Laurens stock in respondent's hands is not a borderline question. That stock was the classic form of capital asset. It represented not merely the capital that respondent had placed at the risk of the Elmvale-Laurens business for an indefinite future period, but the actual seed money that respond-

cit had furnished to permit that business to get underway. In the language of this Court in *Corn Products* (350 U.S. at pp. 50–51), respondent was a "legitimate capitalist" or "speculator," and nothing in that opinion suggests that its status as such would in any way be affected because it looked for commission income as the return on its capital, in place of or in addition to dividend income or capital appreciation.

It is true that this Court stated in *Corn Products* that the capital asset provision was not to be construed in a literal manner that would frustrate the congressional purpose to tax ordinary business income at ordinary income rates. But its holding on the facts there presented can be harmonized with both the language and purpose of that provision if the case is recognized as another application of the principle that "[t]he incidence of taxation depends upon the substance of a transaction." *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334. Although in form the taxpayer in *Corn Products* acquired corn futures—a capital asset—in substance it was engaged in an insurance operation for the protection of its everyday business operations. This was done by acquiring rights to corn in the future. Had corn actually been acquired instead of futures, there would have been no question as to the tax consequences on its disposition. Ordinary, rather than capital, treatment would have been proper because the purchases and sales would produce a "normal source of business income." *Corn Products Co. v. Commissioner*, *supra*, p. 52.

Such treatment is likewise proper where the asset actually purchased represents rights to raw materials which are required in the everyday operation of the taxpayer's business.

This analysis of *Corn Products* is in accord with the first of the cases in which corporate stock was held to be a noncapital asset, *Western Wine & Liquor Co.* v. *Commissioner*, 18 T.C. 1090. The taxpayer there, a wholesale liquor dealer, purchased stock in a liquor manufacturer in 1943 and 1944. It did so because the manufacturer offered each of its shareholders the privilege of purchasing its proportionate share of the manufacturer's bulk whisky at cost. This privilege was valuable to the taxpayer, which was experiencing a wartime shortage of liquor as a result of government restrictions on production. After exercising its rights to purchase whisky, the taxpayer sold the stock at a loss in 1944. The Tax Court held that the loss was in substance a part of the cost of the taxpayer's whisky inventory and was therefore deductible as an ordinary loss. Accord, *Edwards* v. *Hogg*, 214 F. 2d 640 (C.A. 5); *Hogg* v. *Allen*, 105 F. Supp. 12 (M.D. Ga.); *Clark* v. *Commissioner*, 19 T.C. 48; cf. *Gulfline Drug Co.* v. *Commissioner*, 29 T.C. 118, affirmed *per curiam*, 261 F. 2d 238 (C.A. 5).

There are striking similarities between *Corn Products* and *Western Wine*. In each case, the taxpayer purchased an asset, not for itself, but to insure or obtain a source of raw materials to be used in everyday business operations. In each, it was contemplated from the outset that the asset actually purchased—

corn futures or stock—would be disposed of after a relatively short period of time. And, in each, the asset was in fact held only so long as was necessary to accomplish the original purpose. There are only two distinctions between the cases. First, in *Corn Products*, the taxpayer did not ultimately find it necessary to purchase the corn represented by the futures that were sold, while the liquor dealer in *Western Wine* did acquire the whisky represented by the stock. Second, while the futures represented only rights to corn itself, the stock represented not only the liquor, but other assets of the manufacturer in which the liquor dealer had no interest. Neither of these distinctions is legally significant. The outcome in *Western Wine* would have been the same if the whisky shortage had suddenly ended, making it unnecessary for the taxpayer to exercise its purchase privilege, and if the manufacturer's only asset had been its supply of bulk whisky.

Western Wine, like *Corn Products*, stands for the proposition that if a taxpayer acquires one asset solely to obtain another, it will be deemed to have acquired the latter asset, despite the form of the transaction. This principle is well established in the tax law in cases where one corporation purchases the stock of another and shortly thereafter liquidates the acquired corporation to obtain its assets. In such a case, the purchase and liquidation are considered to be part of a series of prearranged and interdependent steps, and they are treated in effect as if the acquiring corporation had acquired the other corporation's assets

directly. *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, affirmed *per curiam*, 187 F. 2d 718 (C.A. 5), certiorari denied, 342 U.S. 827; Internal Revenue Code of 1954, Section 334(b)(2).

Application of the step transaction doctrine embodied in the *Kimbell-Diamond* principle justifies the exceptional treatment of capital stock as a noncapital asset where the stock is purchased to obtain specific assets to be used in the taxpayer's everyday business operations, and this is evidenced by a transitory holding of the stock, which is sold as soon as the underlying assets have been acquired. Only in such a situation can the extraordinary treatment be squared with the language and purpose of Section 1221. That is not the situation in this case. Respondent purchased the Elmvale-Laurens stock, not as a means of acquiring another asset of Elmvale-Laurens to be used in its own business, and not for any temporary purpose, but rather to generate profits in its own business over an indefinite future period. Under these circumstances, the loss cannot be considered to have arisen in the everyday operation of respondent's business, or to have resulted from a transaction in property which was a normal source of business income, notwithstanding the Court of Claims' conclusion (Appendix A, *infra*, p. 33) that respondent purchased and held the stock "as an integral and necessary act" in the conduct of its business. By the very terms of Section 1221, this fact is not relevant.

3. Most of the earlier decisions following *Corn Products* were confined to purchases of stock or debentures as a temporary tie-in to obtaining inventory

or a source of supply needed by the taxpayer in a business emergency.[4] However, more recently, as typified by the decisions in this case and in *Steadman* v. *Commissioner, supra*, the lower courts have extended the so-called *Corn Products* doctrine far beyond the temporary inventory tie-in of that case, to grant ordinary treatment for losses on the sale of stock acquired to obtain a business advantage for an indefinite or permanent period.[5] The theories offered to support these later decisions have no roots in the *Corn Products* rationale, and have introduced a new and potentially limitless concept—business purpose—into the determination of what constitutes a capital asset.

The continuing broadening of the concept of a business asset has prompted two commentators to remark that "[i]t is impossible to predict the outer boundaries of this rapidly expanding concept." Troxell and Noall, *Judicial Erosion of the Concept of Securities as Capital Assets*, 19 Tax L. Rev. 185, 204. Another similarly has viewed the *Corn Products*

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[4] *Tulane Hardwood Lumber Co.* v. *Commissioner*, 24 T.C. 1146; *Arlington Bowling Corp.* v. *Commissioner*, 18 T.C.M. 896; *Smith & Welton* v. *United States*, 164 F. Supp. 605 (E.D. Va.); see also *Commissioner* v. *Bagley & Sewall Co.*, 221 F. 2d 944 (C.A. 2); *Mansfield Journal Co.* v. *Commissioner*, 274 F. 2d 284 (C.A. 6); *Journal Co.* v. *United States*, 195 F. Supp. 434 (E.D. Wis.); *Booth Newspapers, Inc.* v. *United States, supra*; *Electrical Fittings Corp.* v. *Commissioner*, 33 T.C. 1026.

[5] *John J. Grier Co.* v. *United States*, 328 F. 2d 163 (C.A. 7); *Schlumberger Technology Corp.* v. *United States*, 305 F. Supp. 1020 (S.D. Tex.); cross appeals pending in the Fifth Circuit; *Hagan* v. *United States*, 221 F. Supp. 248 (W.D. Ark.); *Pittsburgh Reflector Co.* v. *Commissioner*, 27 T.C.M. 377.

doctrine as "dangerously broad" with "no objective limitations as to its use." Kauffman, *A Second Look at the Corn Products Doctrine*, 41 Taxes 605, 610.[6] The import of these comments is illustrated by a case now pending in the Court of Claims in which a taxpayer-railroad is urging that its stock in another railroad, although held for more than 50 years, was not a capital asset, because it enabled the taxpayer to lease the other road's assets and to operate it as an essential part of its own business. *Union Pacific Railroad Co.* v. *United States*, Ct. Cl., No. 154–310–62.

Lower courts have been unable to agree on what, if any, limitations are to be imposed on the *Corn Products* doctrine. Some courts have suggested that *Corn Products* be confined to cases where the asset was acquired to protect, rather than expand, the taxpayer's existing business, on the theory that an expenditure made to expand a business is more in the nature of a capital outlay than a business expense. *E.g.*, *Smith & Welton* v. *United States*, *supra*; *Weather-Seal, Inc.* v. *Commissioner*, 22 T.C.M. 471; cf. *Chase Candy Co.* v. *United States*, 130 Ct. Cl. 102, 126 F. Supp. 521. Other courts, including the one below, (Appendix A, *infra*, p. 35), have rejected this view, or determined that the test is not applicable in all circumstances. *John J. Grier Co.* v. *United States*, *supra*; *Pittsburgh Reflector Co.* v.

[6] See also Freeman, *Is There a New Concept of Business Asset?*, 36 Taxes 110; Surrey, *Definitional Problems in Capital Gains Taxation*, 69 Harv. L. Rev. 985; Note, *Judicial Treatment of "Capital" Assets Acquired for Business: The New Criterion*, 65 Yale L.J. 401.

Commissioner, supra. A law review commentator has suggested that *Corn Products* should apply only to assets which bear a direct relationship to inventory or to the other statutory categories specifically excepted from capital asset treatment under Section 1221, reflecting this Court's statement in *Corn Products* (350 U.S. at p. 52) that "the definition of a capital asset must be narrowly applied and *its exclusions* interpreted broadly" (emphasis added). See Freeman, *Is There a New Concept of Business Asset?, supra,* p. 112. But the proposal has largely been ignored in the courts. See, *e.g., Steadman* v. *Commissioner, supra; Hagan* v. *United States, supra; Weather-Seal, Inc.* v. *Commissioner, supra; John J. Grier Co.* v. *United States, supra; Schlumberger Technology Corp.* v. *United States, supra.*

There is disagreement in the lower courts not only on what limitations may apply to the *Corn Products* doctrine, but also on what degree of business need must be shown in order to invoke the doctrine. One district court has indicated that *Corn Products* should apply only where an asset is acquired to insure the survival of a business. *Duffey* v. *Lethert,* 63-1 USTC, par. 9442 (D. Minn.). Other courts have held that it is sufficient if the acquisition is reasonable and necessary in the conduct of the business. See, *e.g., Tulane Hardwood Lumber Co.* v. *Commissioner, supra; Smith & Welton* v. *United States, supra; Southeastern Aviation Underwriters, Inc.* v. *Commissioner,* 25 T.C.M. 412; *Livesley* v. *Commissioner,* 19 T.C.M. 133. The court below seemed to

take a stance between these alternatives, holding (Appendix A *infra*, p. 36) that the requisite business need was established where respondent's continuing existence was threatened and, at the very least, it would have had to dissolve its worsted wool division if it did not secure the business of Elmvale-Laurens. On the other hand, in *Steadman v. Commissioner*, *supra*, the Sixth Circuit was satisfied with the fact that the taxpayer purchased stock to retain a corporate client without any proof as to the extent to which the taxpayer's law business would suffer without that client.

4. As the number of decisions we have cited indicates, the question presented here is a constantly recurring one. It has proved to be one of the most confused in tax litigation. Rarely has a tax problem on which this Court has spoken spawned so much litigation and produced such diversity of opinion among the courts and commentators. Moreover, the volume of litigation can be expected to increase in view of the increasing tendency of businesses to acquire interests in related businesses. The confused state of the authorities can be put to rest, the tax status of shares of stock in the hands of individuals and corporations can be clarified, and this fundamental issue

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For other *Corn Products* cases, see *United States v. Rogers*, 286 F. 2d 279 (C.A. 6); *K. S. Services, Inc. v. United States*, 188 Ct. Cl. 874, 413 F. 2d 548; *Bycoflite Corp. v. Williams*, 286 F. 2d 285 (C.A. 6); *KVP Sutherland Paper Co. v. United States*, 170 Ct. Cl. 215, 344 F. 2d 377; *Mississquoi Corp. v. Commissioner*, 37 T.C. 791; and *Old Dominion Plywood Corp. v. Commissioner*, 25 T.C.M. 678.

of federal income taxation can properly be resolved only through review by this Court.

5. Such review also is essential because the business purpose test adopted by the court below and other courts is impossible of even-handed application to situations involving gain and loss on the sale of corporate stock.

If stock is sold at a gain, the taxpayer will simply report the gain as a capital transaction, and given the presumption that stock is a capital asset, it is unlikely to be challenged on audit. Moreover, even if the capital gains treatment is questioned, it is a relatively simple matter for the taxpayer to justify that treatment by showing an investment motive either at the time of acquisition or at some later time prior to the sale of the stock. The resulting gain on the sale inevitably will reinforce the taxpayer's position that the acquisition was a good investment. The fact that the taxpayer had a business association with the corporation in which the stock was purchased will not be sufficient to prove that the stock was purchased solely for a purpose directly connected with the conduct of its business. A taxpayer doing business with a corporation is likely to be in an excellent position to recognize the financial strengths and profit potential of that corporation, and may well be justified in concluding, on the basis of first hand information, that the corporation represents a solid investment opportunity.

If, on the other hand, stock in a business related company is sold at a loss, it is equally easy for the

taxpayer to establish a business motivation for the purchase entitling him to an ordinary loss. This is shown by the considerable success taxpayers have had in litigating this question. The burden imposed on the Commissioner of Internal Revenue is perhaps best illustrated by *Steadman* v. *Commissioner, supra*, where ordinary loss was allowed on the worthlessness of stock despite the taxpayer's written declaration, immediately prior to the acquisition, that his option to purchase the stock was "an exceptionally favorable opportunity" (50 T.C. at p. 372).

In sum, the situation is one in which taxpayers are likely to obtain capital gain treatment if they sell business related stock at a profit and ordinary loss on a sale at a loss. Nothing in Section 1221 of the Code justifies this one-sided application of the capital asset rules. Where Congress has intended that taxpayers have such a result in selling capital stock, it has demonstrated its intention unmistakably by leaving the usual rules applicable to sales at a gain, and providing explicit rules converting what would otherwise be capital loss into ordinary loss. See, *e.g.*, Sections 165(g)(3); 1242, 1243 and 1244 of the Code; see also Section 1234.

In concluding that the corn futures in *Corn Products* were not capital assets, this Court was not unmindful of the practical considerations governing

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Steadman v. Commissioner, supra is again illustrative. The Sixth Circuit there expressly refused to consider whether the taxpayer would have been entitled to capital gains treatment if the corporation in which he had purchased stock had prospered, and he had sold the stock at a time when holding it was no longer necessary to protect his business.

capital gains taxation. It pointed out (350 U.S. at pp. 53–54):

> To hold * * * [that the futures are capital assets] would permit those engaged in hedging transactions to transmute ordinary income into capital gain at will. The hedger may either sell the future and purchase in the spot market or take delivery under the future contract itself. But if a sale of the future created a capital transaction while delivery of the commodity under the same future did not, a loophole in the statute would be created and the purpose of Congress frustrated.

It is ironic indeed that *Corn Products,* which was designed to close one loophole available to a hedger, is now being interpreted in such a manner as to create another more general loophole available to a far greater number of taxpayers and of obviously greater revenue significance.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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JULY 1970.

APPENDIX A

In the United States Court of Claims.

No. 11-65

(Decided November 14, 1969).

WATERMAN, LARGEN & CO., INC. v. THE UNITED STATES

Joseph E. McAndrews, attorney of record, for plaintiff. *Ivins, Phillips & Barker*, of counsel.

Michael H. Singer, with whom was *Assistant Attorney General Johnnie M. Walters*, for defendant. *Philip R. Miller* and *Joseph Kovner*, of counsel.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON and NICHOLS, *Judges*.

OPINION

PER CURIAM: This case was referred to Trial Commissioner, Saul Richard Gamer with directions to make findings of fact and recommendation for conclusions of law under the order of reference and Rule 57(a) [since September 1, 1969, Rule 134(h)]. The commissioner has done so in an opinion and report filed on September 20, 1968. Defendant took no exception to the commissioner's findings of fact but did except to his recommended conclusion of law that the stock purchased by the taxpayer was an ordinary asset, not a capital asset. Plaintiff took no exception to the commissioner's findings of fact or to his recommended conclusion of law. The case has been submitted to the court on the briefs of the parties and oral argument of counsel. Since the court agrees

with the commissioner's opinion, findings and recommended conclusion of law, as hereinafter set forth, it hereby adopts the same as the basis for its judgment in this case.* Therefore, plaintiff is entitled to recover and judgment is entered for plaintiff with the amount of recovery to be determined pursuant to Rule 131(c).

OPINION OF COMMISSIONER

GAMER, *Commissioner:* Plaintiff sues to recover alleged overpayments on its corporate income taxes for its taxable years ending December 31, 1961, and December 31, 1962.

The sole issue is whether the loss on the sale of certain stock which plaintiff owned is, as contended by plaintiff, fully deductible under either section 162(a)[1] of the Internal Revenue Code of 1954 (26 U.S.C. § 162(a) (1964)) as one growing out of an ordinary and necessary expense incurred in carrying on its business, or section 165(a),[2] as an uncompensated loss sustained during a taxable year, or instead is, as contended by defendant, to be treated as a loss incurred on the sale of a capital asset under sections 165(f)[3] and 1211(a),[4] with the limitations on deductibility applicable thereto.

Plaintiff sold the stock in question in 1961, and on its income tax return for such calendar year reported the loss, amounting to $75,000, as a capital loss. However, in 1963 it filed timely claims for refund claiming a deduction as an ordinary loss in 1961 and a net operating loss carryover deduction for 1962. The claims not having been allowed, this suit followed.

In *Booth Newspapers, Inc.* v. *United States*, 157 Ct. Cl. 886, 303 F. 2d 916 (1962), this court enunciated the basic

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*The dissenting opinions of DAVIS, *Judge*, and NICHOLS, *Judge*, follow the opinion of the trial commissioner which has been adopted by the court.

[1] "SEC. 162. TRADE OR BUSINESS EXPENSES.

"(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . ."

[2] "SEC. 165. LOSSES.

"(a) GENERAL RULE.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."

[3] "(f) CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212."

[4] "SEC. 1211. LIMITATION ON CAPITAL LOSSES.

"(a) CORPORATIONS.—In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from

principles governing cases such as these. It pointed out that although section 1221 of the Code defines the term "capital asset" as "property held by the taxpayer (whether or not connected with his trade or business)," (with certain exclusions, such as inventory)[*] and that "[a]s a general proposition * * * capital stock does constitute 'property' and, aside from stock sold by dealers in the usual course of their business, does not fall within any of the express exclusions of section 1221," so that a stock transaction would normally be "encompassed by the literal language of that section," nevertheless, the Supreme Court in *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46, (1955), established an "elastic concept" of the term which, in certain cases, permitted transactions which would otherwise fall within the literal "capital asset" definition to be considered instead as "ordinary" income or loss. 157 Ct. Cl. at 891, 303 F.2d at 920. In the *Corn Products* case, the Court held that the buying and selling of corn futures for the purpose of protecting against price increases of corn, the basic raw material of the taxpayer's business, constituted an integral part of its manufacturing operations and was therefore to be treated as an ordinary business expense, and not as a capital investment or speculation. "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss." 350 U.S. at 52.

After reviewing the various cases of stock transactions by corporate taxpayers which had been decided following *Corn Products* and which had applied the doctrine established thereby, the court in *Booth Newspapers* formulated the governing principles as follows:

> * * * if securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully

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[*] SEC. 1221. CAPITAL ASSET DEFINED.

"For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

"(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business * * *;

> deducted from gross income as a business expense or ordinary loss. If, on the other hand, an investment purpose be found to have motivated the purchase or holding of the securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of the Code.
>
> * * * The fact that securities are "property," in the broad sense of that term, is not conclusive. 157 Ct. Cl. at 896, 303 F.2d at 921.

And, to determine whether the transaction involved thus falls within the "ordinary" or the "investment" category,

> * * * the circumstances of the transaction (its factual background, the necessities of the particular business involved at the particular time involved, and the intentions of the taxpayer, both at the time the securities were originally purchased and at the time they were disposed of) are of crucial importance in the resolution of these cases. *Ibid.*

Applying these *Booth Newspapers* legal principles, and "factual background" criteria, including the "necessities" of plaintiff's business and the "intentions of the taxpayer" at the pertinent times, it is concluded that plaintiff has here carried its burden of establishing entitlement to the deduction in question as an "ordinary" loss.

Plaintiff was incorporated in May 1958 under the name of Waterman, Merrill, Largen & Co., Inc. Its business is the selling, on commission, of various types of yarn produced by its mill accounts. It grew out of the merging of the business interests of three yarn selling companies that had been previously operated by the three principals, Waterman, Merrill, and Largen. Their companies had specialized in the sales, as commission agents, of different types of yarn—Waterman's, based in Providence, Rhode Island, in cotton yarn, Merrill's, based in New York City, in worsted yarn, and Largen's, based in North Carolina, in synthetic yarn. The merging of the three companies into the plaintiff resulted in a single sales agency capable of offering a well-rounded line of yarns. The ability to offer such a broad range has many advantages. For instance, a salesman selling one type of yarn can sometimes discover uses by the customer for other types and thereby effect additional sales.

The largest account that Merrill brought to plaintiff upon its incorporation was that of the Elmvale Worsted Company,

a Massachusetts corporation that manufactured worsted wool yarn at Pittsfield, Massachusetts. This fifty-year-old mill had one of the finest reputations in the country as a quality yarn producer. However, by 1957 it had become an unprofitable business. The dominant force behind the company was Carey R. Kinney, its president and owner of 83 percent of its stock.[6] Kinney and Merrill had been longtime personal and business friends and associates.[7] Elmvale had its own sales force selling its production of worsted weaving yarn. However, in an effort to stem Elmvale's unprofitable operation, Kinney, in the summer of 1957, requested Merrill to undertake a pilot experiment whereby Elmvale would enter the more profitable knitting yarn manufacturing field and Merrill would promote the sales of such yarn upon the usual sales agent's two percent commission. Merrill agreed and, indeed, succeeded to such an extent as, by May 1958, to warrant plaintiff's incorporation and the bringing into it of Merrill's accounts, including Elmvale, as its worsted division. By the latter part of 1958, the account had grown to the point that around thirty percent of Elmvale's production consisted of knitting yarn, with Elmvale becoming the third largest account plaintiff had and the principal factor in the worsted division of plaintiff's business.[8]

However, despite the increasing success Merrill was achieving in transforming Elmvale's production into the more profitable knitting yarns, the effort still did not result in transforming Elmvale into a profitable mill and, in early December 1958, Elmvale decided to terminate operations. Antiquated machinery and labor problems contributed significantly to its plight, as was then the situation in many New England mills. In addition, 1958 was a poor year in the textile industry.

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[6] Kinney also had other related interests. The Kinney Worsted Yarn Company was a one hundred percent owned subsidiary of Elmvale's. There was also a separate dye plant at Pittsfield.

[7] Prior to organizing his own business in 1956, Merrill had been vice president in charge of sales first for the Whitman Yarn Company, one of the largest spinners of worsted yarns in the country, and then for the Abbott Worsted Company in Massachusetts until it went out of business in 1956. He was considered as one of the most experienced and knowledgeable worsted yarn salesmen in the country. Both Waterman and Largen had given him financial assistance to organize his own company in 1956 with the thought that sometime in the future the three might join forces.

[8] Plaintiff's largest account was Carlton Yarn Mills of Salisbury and Cherryville, North Carolina, which operated through various divisions, its second largest being the Firestone Textile Division of Gastonia, North Carolina.

The loss of this account was a serious blow to plaintiff. Elmvale was the most important segment of its worsted division, constituting its only substantial worsted wool account.[9] One of the principal reasons for having organized plaintiff just eight months before was to have such a worsted division. The Elmvale account was a steadily growing one and was, by December 1958, generating commissions at the rate of over $2,000 a month. This amount contributed substantially to defraying the overhead of plaintiff's New York City office, including the salaries of Merrill and another salesman, Heyman, who spent much of their time on the Elmvale account.[10] Plaintiff's own financial situation was weak. While it had been in operation only eight months, plaintiff had, as of December 31, 1958, incurred an operating loss during this poor industry year of over $17,000, and was at that time actually insolvent.[11] Plaintiff had anticipated that the growing Elmvale account would go far toward eliminating the operating loss it was incurring during these first months.

Faced with this serious threat to its corporate existence, at least in its then form, plaintiff (Merrill) diligently attempted to obtain another worsted mill account but did not succeed. Such a selling agency account is extremely difficult to secure.

Kinney's son (whose given name was also Carey, but who is referred to as "Brud") had been associated with Elmvale since 1940. He had worked in every phase of the business, including production, management, and financing. It was the father's hope that his son would ultimately succeed him in becoming the dominant force in the business. In December 1958, he was serving in the capacity of treasurer.

Merrill explored every avenue to save the Elmvale account. Knowing of Kinney's attachment to the Elmvale name and his desire to insure his son's business future, Merrill inquired whether Kinney would be interested in continuing in business if a satisfactory mill could be found in some other location. Kinney replied that such a possibility would be given every

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[9] Because of a conflict of interest, Merrill had dropped another account when he acquired Elmvale.

[10] A third salesman in the office, John Busher, was principally engaged in selling worsted yarns spun from synthetic fiber by the Turbo Orlon Division of Carlton Yarn Mills. Merrill and Heyman were stockholders of plaintiff and Busher had a one-year contract to May 1959.

[11] Its assets were approximately $21,000 and its current liabilities over $47,000.

consideration and Merrill immediately so advised Waterman and Largen.

Very shortly thereafter, still in December 1958, Largen located a mill in Laurens, South Carolina, which produced substantially the same products as Elmvale and which was for sale. Investigation of the prospect then proceeded, including personal visits to the plant by the Kinneys and one of their top production employees, Augeri, as well as by Merrill and Largen. A formal report made after a week-long intensive study by Brud Kinney and Augeri contained favorable findings.

Others with whom Kinney had had business relationships over the years were also interested in the continuation of the Elmvale operation, including Arthur Wellman of the Nichols Fiber Company of Boston, Massachusetts, which was the largest raw material manufacturer for the wool yarn industry, and Harris Bucklin of the Crompton-Richmond Company, Inc., of New York City, which was Elmvale's factor, and some meetings were held in Crompton-Richmond's offices concerning the prospective purchase of the Laurens mill and its operation. Kinney disclosed his willingness to become the dominant stockholder in a new corporation to be organized to take over the assets of the Laurens plant, the corporation to be named "Elmvale Worsted Company, Inc." (*i.e.*, the same name as the Pittsfield company, with only "Inc." added). The new company would be headed by his son as president, who would move south, as would Augeri, who would become head of production. Kinney himself, principally because of his age (70), would not physically move south, but would become chairman of the board of directors. Nichols Fiber Company would continue as the raw material supplier and Crompton-Richmond as factor. As to plaintiff, since there would be no move south by the Elmvale sales force, the opportunity was open to become sales agent for the mill's entire production, *i.e.*, the weaving as well as the knitting yarns. This would, of course, not only assure plaintiff's continued existence, but would open the door to even greater Elmvale commission possibilities.

However, this happy solution to plaintiff's problem was not to be easily realized. Kinney had always felt (a philosophy that was well known in the trade) that a selling agent for

a mill's entire production should have a substantial financial interest in the mill. This would, he believed, produce a relationship in the nature of a joint venture and would thus constitute an incentive to the agent to do a better and more responsible selling job. He had seen many examples of "poor selling" by commission agents, such as effecting sales to financially weak customers, which had in turn resulted in disaster to the mill. Accordingly, at one of the meetings in Crompton-Richmond's offices, Kinney conditioned plaintiff's becoming the new Elmvale corporation's exclusive sales agent upon its putting $100,000 into the corporation's stock.

Plaintiff's three principals then immediately held meetings to consider plaintiff's future course. Plaintiff's finances did not permit such an expenditure. As shown, it was instead insolvent. Nor did the principals themselves have such an amount. They had already made personal loans to plaintiff to keep it going. They concluded, however, that, because of plaintiff's dire need for commissions, they would, in order to continue to exist at all, or at least to exist with a worsted wool division, have to raise the $100,000 somehow to regain the Elmvale account. The Laurens plant was then producing around 25,000 pounds of yarn weekly. Financially, it was just about breaking even. The Kinneys planned to move some of their newer equipment at Pittsfield to Laurens and increase the output to around 30,000 pounds a week or 1,500,000 pounds annually, which, at the then-current market average of around two dollars per pound, would result in gross annual sales of about $3,000,000. At the customary two percent commission, this would produce around $60,000 in commissions for plaintiff, which, even after deducting the substantial selling expenses involved, would still permit the liquidation of the $100,000 indebtedness in two-to-three years. Although the prospects for the mill's becoming a substantial moneymaker were not bright, conditions in the industry and the times not being favorable (1959 was also a poor year, and the industry was, in addition, suffering from foreign import competition), the principals nevertheless felt that it would be able to continue producing for many years on at least a break-even basis, which would permit the generation of commissions in such prospective amount. Although the father Kinney would not move south and actively par-

ticipate in the running of the plant, the son had been well trained to take over the running of such a mill. Furthermore, the father, as chairman of the board, would be available for guidance and advice. Augeri was a well-regarded production man. The excellent Elmvale name was to be retained, as well as, it was hoped, the old customers, since the plant would produce the same type of yarns.

On the above considerations, plaintiff's principals decided to attempt to borrow the $100,000. At one of the previous meetings in Crompton-Richmond's offices, Bucklin had offered to lend Kinney $100,000 to effectuate the purchase of the Laurens mill, but Kinney had declined the offer. Plaintiff's principals decided to ask Bucklin if Crompton-Richmond would lend such a sum to plaintiff. After reviewing the pertinent figures and the prospects for plaintiff's being able to repay the loan out of the prospective commissions, Bucklin agreed to make the loan.

Such loan was thereafter made by Crompton-Richmond to plaintiff, a note evidencing the loan executed by plaintiff (and personally endorsed by the three principals), the new Elmvale corporation formed (sometimes referred to as "Elmvale-Laurens") with Brud Kinney as president, 1,000 shares of the stock of the corporation issued to plaintiff for $100,000 [12] (the stock being pledged to Crompton-Richmond as collateral for the loan), and plaintiff became Elmvale-Laurens' exclusive sales representative.[13] The new corporation commenced operations on June 8, 1959.[14]

For various reasons, Elmvale-Laurens, from the outset, suffered heavy operating losses. The sales plaintiff was able to effect for it, and plaintiff's commissions, fell far below expectations.[15] Adjustments were required in the schedule of payments on plaintiff's note to Crompton-Richmond. Frie-

[12] Kinney's capital contribution was $135,000, of which $35,000 consisted of the value of equipment moved from the Pittsfield mill, for which 1,350 shares were issued (to the Kinney Worsted Yarn Company). The Nichols Fiber Company received 500 shares for $50,000, and 150 shares were issued to stockholders with minority stock interests in the Laurens corporation in exchange for such stock.

[13] To represent plaintiff's interests, Largen became a member of the board of directors.

[14] Elmvale-Pittsfield had terminated operations at the end of February 1959.

[15] Brud Kinney too participated in selling, calling on Elmvale-Pittsfield's old weaving yarn customers. In so doing, he acted in the capacity of an employee of plaintiff, plaintiff paying him $10,000 a year for such services.

tion developed between the mill personnel and plaintiff's sales force handling the account, *i.e.*, Merrill and Heyman.[16]

By February 1961, friction between Brud Kinney on the one hand and Merrill and Heyman on the other had developed to the point that it was concluded Merrill and Heyman could no longer feasibly sell Elmvale-Laurens yarns for plaintiff. An agreement was reached redeeming their stock interests in plaintiff, they resigned as plaintiff's employees, and plaintiff's name was changed to its present form. New arrangements were then made by plaintiff for selling the Elmvale-Laurens yarns. However, the sales situation did not improve, and Elmvale-Laurens' financial condition continued to deteriorate.

Finally, and in good part at the instance of the Nichols Fiber Company, without whose liberal extension of credit Elmvale-Laurens would not be able to exist, Brud Kinney, on June 22, 1961, addressed a letter to plaintiff terminating its agency effective June 30, 1961.[17]

Thereupon, plaintiff, considering that the purpose of its being a stockholder no longer existed, promptly sought to dispose of its 1,000 shares of stock in Elmvale-Laurens.[18] It approached several persons who were considered as possible purchasers, but the only offer it received was one for $25,000 (approximately book value) from one Clifford Brown of Providence, Rhode Island. On July 21, 1961, one month after the termination of its agency, the stock was sold to Brown at such price, resulting in a $75,000 loss. It is the proper treatment of this loss[19] as "ordinary" or "capital" which is the subject of the dispute herein.

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[16] Elmvale-Laurens felt plaintiff was not obtaining the best possible prices for the mill's products, but plaintiff considered the mill to be unrealistic and that sales were being lost as a result. In addition, plaintiff complained about the poor quality of yarn being produced. Large quantities of yarn which plaintiff sold were rejected and returned by customers.

[17] By letter of May 12, 1961, to John L. Stickley & Co., one of plaintiff's competitors (with copies to plaintiff and Brud Kinney), Wellman suggested Stickley's taking over certain of the Elmvale-Laurens accounts and such accounts were thereupon transferred to Stickley by Elmvale.

[18] Plaintiff did not believe its agency was so terminable at the will of the mill, and considered instituting a suit. However, the mill was in such poor financial condition that plaintiff concluded a suit would not be worth the expense involved. As of March 31, 1961, Elmvale-Laurens was running a deficit in working capital of around $160,000.

[19] Plaintiff ultimately liquidated the $100,000 indebtedness to Crompton-Richmond in 1964.

The above-recited facts leave little doubt that the circumstances underlying the purchase and sale of the Elmvale-Laurens stock qualify the loss as an "ordinary" one. This was the only way plaintiff could regain the lost Elmvale account, its only substantial wool worsted account and one of the mainstays of its worsted division, and, at the time, avoid liquidation or, at least, the dissolution of its worsted division, the establishment of which was the prime purpose of its having been organized in the first place. It seems plain that the situation falls within the *Booth Newspapers* principle as "securities * * * purchased by a taxpayer as an integral and necessary act in the conduct of his business" and that plaintiff was not "motivated" by "an investment purpose" in the "purchase or holding of the securities," at least in the sense in which the term "investment" is used in these cases.

While, as *Booth Newspapers* points out, the result, in cases involving this problem, normally depends upon the particular facts of the individual case showing the purpose of the purchase and holding of the securities,[20] the facts in the instant case are similar to those in which purchases of securities were made to effectuate the continued supply of vital materials or inventory upon which a business depends, and in which the losses involved were held to have been incurred in the ordinary course of business and not as stock investments. *Booth Newspapers, Inc., supra* (purchase by newspaper during a shortage period of stock in paper mill to insure supply of newsprint);[21] *Electrical Fittings Corp.*, 33 T.C. 1026 (1960) (purchase by electrical conduit fittings manufacturer of stock in ductile iron foundry to obtain, during shortage period, a supply of required castings); *Helen M. Livesley*, 19 T.C.M. 133 (1960) (purchase by potato wholesale dealer of stock in potato shipping company to obtain a dependable potato source); *Arlington Bowling Corp.*, 18 T.C.M. 896 (1959) (purchase by operator of bowling alleys of stock in bowling pin manufacturing corporation to insure, during a shortage period, a source of supply of pins); *Smith & Welton*

[20] "Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances." *Commissioner* v. *Heininger*, 320 U.S. 467, 475 (1943).

[21] *Journal Co.* v. *United States*, 195 F. Supp. 434 (E.D. Wis. 1961), similarly held as ordinary a loss on paper mill shares bought by a newspaper publisher to obtain newsprint inventory during a shortage period.

v. *United States*, 164 F. Supp. 605 (E.D. Va. 1958) (purchase by department store of shares of manufacturer of ladies' suits to maintain continued supply of the line); *Tulane Hardware Lumber Co.*, 24 T.C. 1146 (1955) (purchase by a lumber dealer of debentures of a plywood manufacturer to insure a source of plywood);[22] *Western Wine & Liquor Co.*, 18 T.C. 1090 (1952) (purchase by wholesale liquor dealer, during a whiskey shortage, of shares of distiller to obtain whiskey inventory).[23]

Even closer to the instant case on the facts is *Southeastern Aviation Underwriters, Inc.*, 25 T.C.M. 412 (1966), where the loss on the purchase, by an aviation insurance manager, of shares in an insurance company, made to replace a lost management contract on which the taxpayer had earned substantial commissions, was held to constitute an ordinary business expense, as well as *Hagan* v. *United States*, 221 F. Supp. 248 (W.D. Ark. 1963), where such a deduction was also allowed on the loss incurred by a salesman on stock purchased in a customer's business to insure that the customer would continue to make its exclusive purchases through him and on which he earned substantial commissions.

Defendant contends that plaintiff purchased the Elmvale-Laurens stock not, as a temporary expedient, to maintain its existing business, as was true in some of the "source of sup-

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[22] In *Logan & Kanawha Coal Co.*, 5 T.C. 1298 (1945), a wholesale coal dealer which sold for its own account, as well as on commission, purchased stock in several of the coal companies which supplied it with coal for the primary purpose of maintaining favorable relations with such companies and thereby enabling it to acquire and maintain sources of supply. The Tax Court held that losses on the sales of such stock constituted capital losses since shares of stock, being "property," were capital assets as defined by the Code and that, under the circumstances, the shares in question did not fall within any of the statutory exceptions (inventory, etc.). Thereafter, in *Commissioner* v. *Bagley & Sewall Co.*, 221 F. 2d 944 (2d Cir. 1955), the Second Circuit held that a loss incurred as a result of the required posting of Government bonds as security for the performance of a contract was an ordinary loss since it was incurred only as an incident of carrying on the business of the taxpayer. It rejected the theory that simply because a security constitutes a "capital asset" under the Code, a loss incurred on the purchase and sale thereof necessarily constitutes a capital loss and instead held that it was not possible to "wrench" the purchase and sale from "its setting," (at 947) all the facts and circumstances relating thereto being required to be examined. In *Tulane Hardware*, the Tax Court held that in view of *Commissioner* v. *Bagley & Sewall Co.*, its previous decision in *Logan & Kanawha Coal Co.* would no longer be considered as authoritative.

[23] *Charles A. Clark*, 19 T.C. 48 (1952); *Edwards* v. *Hogg*, 214 F.2d 640 (5th Cir. 1954); and *Hogg* v. *Allen*, 105 F. Supp. 12 (M.D. Ga. 1952), are similar whiskey supply cases.

ply" cases, but, instead, for the purpose of expanding its business on a permanent basis. It points out that when Elmvale-Pittsfield decided to cease operations plaintiff was earning commissions from it at the rate of around $25,000 a year while plaintiff hoped to realize commissions from Elmvale-Laurens of around $60,000 a year. It argues that expenditures for expansion, exceeding those necessary to the conduct of an existing business, are recognized as capital investments.

It is true that when expansion is the underlying basis of the stock purchase, without any showing of business necessity relating to the perpetuation of the life of the existing business, the expenditure has been regarded to be in the nature of a capital investment rather than an ordinary and necessary business expense. *Chase Candy Co.* v. *United States*, 130 Ct. Cl. 102, 126 F. Supp. 521 (1954); *Duffey* v. *Lethert*, 11 A.F.T.R. 2d 1317 (D. Minn. 1963); And in *Smith & Welton*, *supra*, the court, in sustaining the loss there involved as an ordinary and necessary business expense, drew a distinction between cases in which securities are acquired to obtain an advantage which did not previously exist as against situations where securities are purchased to protect what is presently existing but threatened.[24]

However, accepting these principles,[25] it seems plain they should not be so rigidly applied as to encompass a situation such as the instant one where the increase in business is so intimately linked to continued existence and such existence is the basic reason for the purchase. Increased business may well flow from continued life, but an expenditure basically designed to insure continued life should not be denied its status as an ordinary and necessary business expense simply because it may also possibly result in business enlargement. In *Booth Newspapers*, this court did not hesitate to place the

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[24] *Cf. Weather-Seal, Inc.*, 22 T.C.M. 471 (1963), where, in holding losses on the purchase by a manufacturer of stock in retail outlets to be fully deductible as a business expense since the stock "was acquired for reasons of business necessity and not for investment purposes" (at 474), the court emphasized that the stock purchase plan was not aimed at acquiring new business but only to retain existing business.

[25] In *Helen M. Livesley, supra*, the court felt that, in order for a stock purchase to constitute a reasonable and necessary act in the conduct of a business, the taxpayer is not required to go so far as to prove that, absent the purchase, his business would have been crippled or would have failed. "Responsible businessmen make legitimate expenditures every day, which would not measure up to such a 'survival' test." 19 T.C.M. at 140.

stock loss resulting from the newspapers' attempt to obtain a full supply of newsprint in the "ordinary and necessary" category even though, as the findings show, the tonnage of newsprint replaced substantially exceeded the tonnage lost during the shortage. Similarly, in *Southeastern Aviation Underwriters, Inc., supra*, the loss on the stock purchase, made for the purpose of replacing the lost management contract on which the taxpayer had earned substantial commissions, was held to constitute an ordinary business expense although the facts showed a very substantial increase in commissions under the new contract. It was the attempt to replace the loss of an important commission account which threatened the taxpayer's survival that was determinative. The record shows that the same economic necessity motivated plaintiff in the instant case.

Defendant further says that plaintiff's purchase of the Elmvale Laurens shares should be regarded as capital in nature because (a) the stock "at the time of its purchase appeared to be a particularly attractive investment";[20] and (b) plaintiff had no assurance it would continue to earn commissions since its agency was terminable at the will of the mill, so that the purchase should therefore be considered separately as an investment, disassociated from the commission problem.

The record does not support these contentions. First, the evidence does not fairly support any conclusion to the effect that plaintiff's motivation was the opportunity of making "a particularly attractive investment." The Laurens mill at the time of plaintiff's stock purchase therein was only breaking even. The times were not propitious for dynamic growth by woolen mills. The years 1958 and 1959 were poor ones in the industry. Competitive imports presented a serious problem. The evidence is plain that plaintiff was not seeking an attractive stock investment in the sense of capital appreciation or a source of dividends. It was primarily interested only in a source of commissions to replace the lost Elmvale-Pittsfield account, to save its woolen division, and to avoid liquidation. Plaintiff was hardly in a position to be seeking stock investments. This was not a situation of an investor seeking an outlet for surplus funds. Plaintiff was, instead, insolvent. To

[20] Def.'s Brief, p. 15.

make this purchase it had to borrow the entire sum. The record makes plain that the purchase was not its idea or desire at all but that it felt obliged to make it because that was the condition imposed upon it by Kinney for plaintiff's becoming the mill's commission-agent. As the court said in *Booth Newspapers*, "The difficulty with defendant's position is simply that the record will not support a conclusion that plaintiffs were investment-minded when they purchased the stock." 157 Ct. Cl. at 896, 303 F. 2d at 921. Plaintiff had never before nor has it ever since owned stock in any other corporation, a fact which, in cases such as these, has been given important weight. *Arlington Bowling Corp., supra; Electrical Fittings Corp., supra; Hagan* v. *United States, supra; Tulane Hardware Lumber Co., supra; Western Wine & Liquor Co., supra.* However, the fact that an expenditure is of a once-in-a-lifetime type does not prevent it from falling within the category of an "ordinary" business expense. *Welch* v. *Helvering*, 290 U.S. 111 (1933); *Planters Exchange, Inc.* v. *United States*, 57-1 USTC ¶ 9565 (N.D. Fla. 1957); *Western Wine & Liquor Co., supra.*

It is true that plaintiff did not expect the Laurens mill to flounder as it did. With a continuation of the Elmvale name, as well as the Kinneys' dominant financial interest and management, and a top Elmvale-Pittsfield production official heading up the production at Laurens, plaintiff reasonably expected Laurens to continue for many years on at least a break-even basis. But this was all that was necessary for plaintiff to earn substantial commissions over such years.

On the terminability question, plaintiff denies that Elmvale-Laurens had the legal right to terminate its agency agreement, contending that its $100,000 stock purchase differentiates its situation from that of the usual commission agent in this industry, wherein agency arrangements are normally terminable at the will of the mill. It is, however, not necessary to decide this disputed legal issue since it would not, in any event, affect the outcome. Plaintiff had every assurance that it would, if it met the stock-purchase condition imposed, be Elmvale-Laurens' exclusive commission agent and there was no reason to doubt the bona fides or the permanency of the arrangement. Plaintiff had previously and successfully acted as Elmvale-Pittsfield's knitting yarn sales

agent, and Merrill and Kinney had had a long and cordial business and social relationship. The legal right of Elmvale-Laurens to terminate the agency, even assuming there was such a right, would not affect the conclusion that the reasonably expected continued receipt of Elmvale commissions was the underlying reason for effecting the stock purchase.

Finally, defendant argues that, "even if the stock was noncapital when acquired, the taxpayer changed the character of the securities by holding the stock for over three years since it could have sold it (except to another sales agent) without jeopardizing its exclusive agency with Elmvale-Laurens." [27]

The record also fails to support this contention. The stock-purchase condition imposed on plaintiff by Kinney was based upon the theory that an agent having a financial interest in the mill would perform better. A sale of the stock while plaintiff was still acting as agent would frustrate the entire purpose of the arrangement. Defendant's assertion that plaintiff was free to sell the stock (except to another commission agent) at any time after its purchase is based on Brud Kinney's testimony to such effect. However, he was not present at the particular meeting at which his father had imposed the requirement, and the understanding of all of plaintiff's principals, which was the only rational one under the circumstances, was that plaintiff was obligated not only to purchase the stock but to retain it during the period it was acting as commission agent. As soon as plaintiff's agency was terminated, plaintiff disposed of the stock to the only person from whom it obtained an offer.

As the cases upon which defendant relies show, *Gulftex Drug Co.*, 29 T.C. 118 (1957), *aff'd per curiam*, 261 F.2d 238 (5th Cir. 1958); *Missisquoi Corp.*, 37 T.C. 791 (1962), it is true that securities originally acquired as an "integral and necessary act in the conduct of [a] business," (*Booth Newspapers*, *supra*, 157 Ct. Cl. at 896, 303 F. 2d at 921) and therefore noncapital at such time, may assume the nature of a capital investment if held substantially beyond the time when the acquisition of the stock has served its purpose. As shown, however, the facts herein do not fall within the ambit of this rule.

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[27] Def.'s brief, p. 16.

For all the reasons stated above, plaintiff is entitled to recover. The amount of the recovery should be determined pursuant to Rule 131(c).

DAVIS, *Judge*, dissenting:

I have been persuaded by Judge Nichols' analysis and his general approach, but I cannot join in all the observations in his opinion. He seems to me quite right in stressing that (a) if the test is to remain (in shorthand) investment-mindedness vs. business-purpose, that gauge must be applied to the objective situation, rather than to the secret, unexpressed-at-the-time subjective intention of the taxpayers; (b) there are grave dangers in elevating the uncommunicated subjective intention of the taxpayers to a dominant, or important, role in applying the standard; and (c) in this case, the senior Kinney's insistence that the taxpayer invest in the new company, and taxpayer's acquiescence in that demand without any demur, require the conclusion that, objectively viewed, one of the taxpayer's substantial purposes had to be investment, *i.e.* an interest in the profitability of the new company (and not solely in the taxpayer's commissions). I note, in addition, that I am not yet convinced that the standard of investment or business purpose is appropriate for this type of case in which a permanent acquisition of stock is made, and I reserve my position on that point since the court accepts the investment test in this instance without further examination.

NICHOLS, *Judge*, dissenting:

This is an action to recover alleged overpayments of corporate income taxes for the calendar 1961 and 1962 taxable years. Plaintiff originally showed on its returns a loss on a sale of capital stock as capital losses, but after becoming aware of certain court decisions filed claims for refund. Its position now is that the losses are deductible as ordinary and necessary business expenses (Internal Revenue Code of 1954, Sec. 162(a)) or as an uncompensated loss sustained during the taxable year (Internal Revenue Code of 1954, Sec. 165(a)). Defendant says the loss was incurred on the sale of a capital asset under §§ 165(f), 1211(a), and 1221, with the limitations on deductibility applicable thereto. These are that such losses are allowable only to the extent of capital

gains. The returns reflected no such capital gains. I agree with defendant's position.

The facts are set forth in the findings and are repeated here only to the extent necessary to give the setting for my conclusions of law.

Plaintiff was incorporated in May 1958, and its business was and remained to sell, on commission, various types of textile yarn produced by its mill accounts. Separation of the function of selling from production had been common in the textile industry. It was important for such a concern to be able to offer vendees all the various types of yarn, and its organization brought together three specialists in various yarns. Mr. Merrill, one of the organizers, brought into the new concern an account with Elmvale Worsted Company, a Massachusetts corporation, of Pittsfield, Massachusetts. Its product had been wool weaving yarns almost exclusively, but Mr. Merrill had induced it to stress wool knitting yarns, believed at that time to be a more promising line. He had sold for it all its production of knitting yarns amounting to one fourth to one third of its business, on the 2% commission standard in the industry. Persons not here involved effected the remainder of Elmvale's sales.

But Elmvale Worsted was still not returning a profit and Mr. Carey E. Kinney, who owned 83% of its stock, informed Mr. Merrill that it must close. The industry at that time was in grave difficulties because of the competition of low-cost imports. The record also reflects that the textile industry was a low-wage one, by American standards, and that Massachusetts had become a high-wage area because of the impact of the prosperous electronics industry. This naturally created labor difficulties for Elmvale, as for other Massachusetts textile concerns. Besides, Elmvale's plant was antiquated.

Mr. Merrill put forward the idea to Mr. Carey Kinney that he might organize a new company, to operate in the South, as an alternative to merely closing. To plaintiff the loss of commissions on Elmvale sales was only one aspect of the threatened disaster: the unbalancing of its line was another. It was committed to carry certain high-salary personnel and could not reduce its overhead to adjust to the threatened loss of business. Thus it had every incentive to help keep Mr. Carey Kinney in production in one way or another.

The latter was receptive to the idea, largely because he desired to secure a career in the textile industry for his son, generally referred to in the record as "Brud" Kinney. Mr. Merrill and another principal owner of plaintiff, Mr. Largen, located a plant that could be purchased at the small town of Laurens, South Carolina. This plant could spin worsted yarn and, supplemented by some machinery from Pittsfield, could produce enough knitting yarn to keep plaintiff in the business. It was a going concern with an experienced labor force.

A deal was now worked out according to which a new corporation was to be formed to operate this plant. Its name was to be Elmvale Worsted Company Inc., *i.e.*, the same as the Pittsfield concern with the addition of "Inc." Brud Kinney would manage it and his father would be Chairman of the Board but would not move South. Every effort would be made to maintain the high reputation of the Pittsfield concern and sell the same products to the same customers.

It was agreed that plaintiff was to be the exclusive sales agent, which meant it would get its 2% commission on every pound that was sold, whether it effected the sale itself or not. As usual in the industry there was no formal or even informal agreement as to how long the agency would last or how it could be terminated.

The elder Kinney, however, insisted that he would not put plaintiff in that position unless it subscribed to stock in the new company. His purpose in taking this position was to eliminate a conflict of interest he deemed to exist as between selling agents and mills, when wholly independent financially. Mills, to earn a profit, had to work on long production runs of uniform specifications. Agents, however, to enlarge their commissions would load up the order board with variegated small orders necessitating frequent interruptions of production. The commission was earned whether or not the order was filled at a profit. Plaintiff's officers fully understood Mr. Kinney's position and his reasons for it, to the extent that Mr. Merrill anticipated that Mr. Kinney would make this demand even before he made it. Whether because of similar thinking or not, the complete independence of mill and agent that once had prevailed had become somewhat exceptional in that industry. There is nothing to suggest that Mr. Kinney could not have obtained the needed capital else-

where. In fact, plaintiff was practically insolvent, had no funds available for investment, and it borrowed the $100,000 it was required to put up from a factor who would have loaned the money direct to Elmvale just as readily. For this $100,000 it received ⅓ of the stock, and nominated Mr. Largen to serve on the Board of Directors.

The rest of the stock went to the Kinneys, to the supplier of the raw material, wool tops, who put up $50,000, and a small amount to the former owners of the Laurens plant.

According to Mr. Waterman, the president and treasurer of plaintiff (R 40):

> We felt that with Mr. Kinney's background and experience in worsted manufacturing and with Mr. Wellman, who was the largest top maker in the country, and with Mr. Merrill's experience, broad experience in the field of selling worsted yarns that the operation should be successful. We didn't expect any great General Motors out of it, but we felt it would be a successful operation that would remain in business for a number of years and generate commissions to us.

They did not buy the stock for appreciation in value or dividends, but to get the commissions. They "would not have been upset" by an appreciation in value "but that was not the purpose." Appreciation appeared unlikely, since at that time worsted yarn organizations were "not very successful." On the basis of full production they "hoped and expected" to get $60,000 a year in commissions, out of which allocable salaries and other overhead would have to be paid. Still, they hoped to earn enough money from the account to pay off the loan from the factor in two to three years.

This was the only stock purchase plaintiff had ever made, up to the time of trial.

It is of interest to note that the principals of the plaintiff corporation hardly hoped that their commissions from Elmvale and all other sources would do more than pay their own salaries: for plaintiff, too, dividends or stock appreciation were a long way off at best. Such was the state of this once flourishing industry.

As it turned out, even these modest hopes were dashed. For reasons not made clear in the record, Elmvale Worsted Company Inc. was consistently unsuccessful, both as to gross volume and as to profits. It became heavily in debt to the wool top supplier. What Winston Churchill called

"the diseases of defeat" began to appear. Among these people, who were too gentlemanly and understood each other too well to need written agreements, there developed something like acrimony. In the spring of 1961 the gulf between Mr. Merrill and Brud Kinney became too deep for the former to continue handling the account. He was persuaded to withdraw amicably from the plaintiff corporation and others were employed to take the account over. Nevertheless, Mr. Wellman, the wool top supplier, who to all intents was in control of Elmvale Inc. owing to its unpayable debt to him, began to angle with other agents. On June 22, 1961, Brud Kinney sent plaintiff a notice in writing that the agency was terminated effective June 30.

Plaintiff's officers were naturally irate at this. They had supposed in some vague way that their stock purchase removed their agency relationship from the category of those that were terminable at will. They consulted South Carolina counsel who gave them little encouragement. Apparently the only thing counsel could think of was some kind of minority stockholder's suit, which he thought would be futile because of the insolvency of Elmvale Inc. If they appeared to be getting anywhere in the suit, Mr. Wellman could seize the assets in collection of his debt, leaving an empty shell for the litigants.

Plaintiff was left with its $100,000 debt to the factor, which it honored and paid in full. It endeavored to sell the stock and was able to realize but $25,000. The difference, $75,000, is the loss whose proper tax treatment is at issue here.

There can be no doubt that from the accountant's point of view the investment was a capital investment and the loss a capital loss. Mr. Brown, a qualified CPA, so treated them on the plaintiff's books and tax returns. He testified he would treat an inventory loss as an ordinary loss. He was asked (R 181):

> Q Why did you treat this loss differently?
> A Because I had considered this as an investment in a capital asset.
> Q Why?
> A Because that's what it was.

It is not unusual in these cases, nor decisive, for the taxpayer to repudiate the treatment originally given the transaction on its books or tax returns. It ought to give pause when the

accountant still says he was right the first time. However, there appears to be a divergence between the accounting and the legal point of view in the present premises. The source of this divergence, its nature, and extent, are for consideration here.

The landmark case is *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955). That taxpayer, in the business of producing corn sugar and other corn products, had become accustomed to purchase corn futures at harvest time each year, at favorable prices, to guard against high prices due to droughts before the next harvest. At times it sold these futures and purchased spot corn instead. It claimed the futures were capital investments and that gains when realized were entitled to capital gains treatment. The Court held otherwise, viewing the transactions as an "integral part" of the business, "a form of insurance against increases in the price of raw corn" (p. 50). "Congress intended that profits and losses arising from the everyday operations of a business be considered as ordinary income or loss rather than capital gain or loss" (p. 52). The capital gains provision, being "an exception from the normal requirements of the Internal Revenue Code" must be construed strictly. Thus, in effect, the specific exceptions such as stock in trade or inventory to the capital asset definition in Internal Revenue Code, Sec. 1221, were held not to comprise all the exceptions there were.

In *Booth Newspapers Inc.* v. *United States*, 157 Ct. Cl. 886, 894, 303 F. 2d 916, 920 (1962); this court referred to the *Corn Products* rule as an "elastic concept" which in certain cases would permit transactions which would otherwise fall within the literal definition of a capital asset to be considered instead as ordinary income.

United States v. *Rogers*, 286 F. 2d 277 (6th Cir. 1961), *cert. denied*, 366 U.S. 951, *reh. denied*, 368 U.S. 870, illustrates the converse of *Corn Products:* taxpayer, a cattle dealer, bought and sold futures in other commodities with the idea that somehow he was hedging. The court held these were capital transactions because not integral to the business.

The largest class of cases following *Corn Products* consists of those (commonly referred to as "source of supply cases") where, as in *Corn Products* itself, a purchase of securities or other assets, normally capital, is made as an expedient to tide the buyer over a period of shortage and high prices of some

material vitally needed in its business as stock in trade or inventory. Our own *FS Services Inc.* v. *United States*, 188 Ct. Cl. 874, 413 F. 2d 548 (1969), and *Booth Newspapers Inc.* v. *United States*, *supra*, decisions are perhaps typical. Booth Newspapers had bought stock in a paper mill during a period of acute newsprint shortage to assure a newsprint supply. FS Services bought a refinery during a period of acute shortage of petroleum products, which FS Services had to have to supply to its customers. In both cases this court assured itself (a) that the taxpayers knew they were acquiring property that would not be attractive to them to own in the long pull, after the shortage ended, and (b) that there was an intention to dispose of the acquisition when the shortage ended, which was carried out with reasonable promptness. In *Booth*, the acquired plant made high-quality writing and book paper and had to be converted to make newsprint which even so was of poor quality. In *FS Services*, the purchased refinery was outclassed in efficiency by newer plants and would become obsolete as soon as a sufficient number of the latter were in stream. Obviously, either taxpayer might have decided to become an integrated producer as a permanent thing, producing its own raw material or inventory. To have held the purchase not a capital transaction in such a case would be to make a dent in the legal concept of a capital transaction not warranted by anything said or done in *Corn Products*. We referred with approval to *Missisquoi Corp.*, 37 T.C. 791 (1962); and *Gulftex Drug Co.*, 29 T.C. 118 (1957), *aff'd per curiam* 261 F. 2d 238 (5th Cir. 1958); in both of which the investment was held capital because held too long after the supply emergency ended. Defendant cited the above two cases in *FS Services*, but we held them not applicable there because *FS Services* started trying to get rid of its refinery when no longer needed with reasonable promptness as we thought.

Other cases allowing ordinary loss or requiring ordinary gain treatment for this kind of "source of supply" transaction are: *Smith & Welton* v. *United States*, 164 F. Supp. 605 (E.D. Va. 1958); *Electrical Fittings Corp.*, 33 T.C. 1026 (1960); *Tulane Hardwood Lumber Co.*, 24 T.C. 1146 (1955); *Helen M. Livesley*, 19 T.C.M. 133 (1960); *Arlington Bowling Corp.*, 18 T.C.M. 896 (1959); *Edwards* v. *Hogg*, 214 F. 2d 640 (5th Cir. 1954); *Journal Company* v. *United States*, 195

F. Supp. 431 (E.D. Wis. 1961); *Mansfield Journal Co. v. Commissioner*, 274 F. 2d 281 (6th Cir. 1960).

In arriving at our recent *FS Services* decision we concluded that no innovation was required of us then. On the facts found, precedents binding on us dictated the result. The main thrust of defendant's efforts were to refute our commissioner's fact findings which, if accepted, were practically conclusive.

Purchases of stock wholly or partly to obtain employment must be common. Many stockholders of closely held corporations must expect to be employed to render the corporation services they are capable of rendering, which the corporation needs. Yet the cases applying *Corn Products* to stock purchases made with this motive are not very numerous. Examples are: *Hagan v. United States*, 221 F. Supp. 248 (W.D. Ark. 1963), (plaintiff, a commission salesman, purchased stock in a business he had been selling to in order to retain it as a customer. The stock became worthless. Held, ordinary loss.) *Southeastern Aviation Underwriters*, 25 T.C.M. 412 (1966), (plaintiff, an aviation insurance manager, bought stock in an insurance company so as to be employed by it as its aviation insurance manager; later he sold stock at loss. Held, ordinary loss.) *Charles W. Steadman*, 50 T.C. 369 (1968), (plaintiff, an attorney, bought stock in a corporation of which he was secretary and general counsel in order to avert a change of control which would have cost him these jobs and the fees incidental. Stock became worthless. Held, ordinary loss. There is a dissent asserting it was not shown the corporation was a vital source of taxpayer's practice. This case is on appeal in the 6th Circuit.). See also, Troxell and Noall, *Judicial Erosion of the Concept of Securities as Capital Assets*, 19 Tax Law Review 185, 204 (1964) and authority cited.

These cases, like the one at bar, clearly fall outside all the statutory exceptions to the capital asset concept. For this reason, before they were decided one commentator suggested that the "source of supply" cases would not be precedents for a case:

> * * * On the other hand, where the purchase is to acquire a long-term (capital) right, such as an exclusive agency * * *. Freeman, *Is There A New Concept Of Business Asset?* 36 Taxes 110, 112 (1958).

This comment would be more helpful if not made by Freeman in course of an attempt to demonstrate that *Corn Products* and other source of supply cases fall within the inventory exception, an analysis I find to be strained. Most commentators agree, reasonably in my opinion, that the Supreme Court did intend to engraft a new exception on to Sec. 1221 in addition to the inventory exception. Brown, *The Growing "Common Law" of Taxation*, 34 S. Cal. L. Rev. 233, 249 (1961); Chirelstein, *Capital Gain And The Sale Of A Business Opportunity: The Income Tax Treatment of Contract Termination Payments*, 49 Minn. L. Rev. 1, 41 (1964); Kauffman, *A Second Look At The Corn Products Doctrine*, 41 Taxes 605 (1963); Surrey, *Definitional Problems In Capital Gains Taxation*, 69 Harv. L. Rev. 985, 993 (1956); Troxell and Noall, *Judicial Erosion Of The Concept Of Securities As Capital Assets*, 19 Tax L. Rev. 185 (1964); Tucker, *The Warren Court: Its Impact On The Capital* vs. *Ordinary Concept Under The Internal Revenue Code*, 17 Kansas L. Rev. 53, 59 (1968); Note, *Judicial Treatment Of "Capital" Assets Acquired For Business*, 65 Yale L.J. 401, 406 (1956). The Freeman comment does validly suggest the point, however, that the source of supply cases have a conceptual nexus with the express statutory exception in Sec. 1221 for inventory, which is lacking in the case of purchases of stock to secure a source of employment. It could well be that the Congress which enacted the inventory exception would have added an explicit exception for stocks purchased primarily to secure a source of inventory, if it had thought of it, for otherwise the apparent statutory plan is imperfectly expressed. No such argument can be made in the case of a source of employment stock purchase.

Thus the Supreme Court's *Corn Products* case had a take-off point in the language of the statute which is lacking here. Moreover, the decided cases cited to us do not provide a body of law in the source of employment field which can be deemed *stare decisis* in this court. The most I can derive from the cases and comments is that the court should not flinch away from an innovative approach to accomplish the statutory scheme more perfectly, merely because some critics might call it judicial legislation.

Still, if we are to make new tax rules, we should do so in responsible fashion. The defendant points out with some

justice that in any case where possible employment came as one of the usufructs of stock ownership, a business rather than an investment motive could be asserted if the stock were sold at a loss, and forgotten if it were sold at a profit. It is not lightly to be supposed that the Congress intended to present taxpayers with so golden an opportunity to manipulate the facts to secure a tax advantage. To assuage the defendant's concern, it is necessary to ascertain the presence of business as against investment purpose by manifestations in the external world rather than merely by subjective intent allegedly locked in the taxpayer's breast and first disclosed years later. Then the taxpayer would have to accept tax consequences unfavorable to himself if he sold at an advance stock he had purchased with predominant business motivation. I think this is the kind of equitable balance the Supreme Court intended to bring about in *Corn Products*.

This kind of external evidence presumably would exist if the stock manifestly did not have the market value the taxpayer put out for it. Then it might be inferred the purchase was really a disguised kickback or rebate to secure employment. But that is not this case. Taxpayer does not seriously contend that the stock was overpriced or that the new corporation did not have good prospects. On the other hand, taxpayer does not offer any clear extrinsic proof that the case is not the ordinary one of the investor hoping for employment as one of the usufructs of stock ownership.

If plaintiff's officers remember their motives correctly, they did not reveal them at the time to their co-entrepreneurs. The whole point of getting $100,000 of capital indirectly from the factor through plaintiff, rather than directly from the factor, was to secure the services of an agent who would be investor minded. Yet the officers now say their sole object was commissions, just as if they held no stock. Of course, if they had said this to Mr. Kinney, Sr., at the time, the whole deal would have been off. In effect they say they were withholding from Mr. Kinney what he had bargained to receive.

If taxpayer bought the stock only to obtain the agency, it is remarkable it did no more to assure that the agency would not be terminable by the principal at its will. It is true they say that somehow, they thought their stock ownership took the agency out of the at will category, but they do not explain how, instead of at will, they expected it to be terminable.

Surely they did not imagine it to be terminable under no conditions! If they thought their stock purchase was an investment, their failure to tie in their purchase to the duration of their agency is at once explained. This point by itself cannot be deemed conclusive, however. The exhaustive analyses by Troxell and Noall, *cit. supra*, shows the existence of some source of supply cases where the taxpayer acquired an interest, but not control.

When the principal terminated the agency, in plaintiff's eyes wrongly and prematurely, plaintiff took no steps to rescind the entire transaction.

Plaintiff says its need for the agency was so great as to put it under virtual duress, under all the circumstances, as recounted *supra* and in the findings. However, it appears Mr. Kinney was just as much in need of plaintiff, as plaintiff was of him. Only plaintiff's Mr. Merrill had developed the market for wool knitting yarns which the new business was to exploit. Elmvale Worsted Company, Inc., was born because of the need of all its principals for one another. There is anyway, nothing to show that plaintiff was so desperate it could not bargain with Mr. Kinney on an arm's-length basis and negotiate for relief from any conditions it deemed unfair or onerous.

I do not view this analysis of the facts as in conflict with Finding 29 because I read that finding as referring to a state of mind that was never disclosed to anyone until plaintiff's officers testified in this case. Not even to their own accountant! I do not dispute that they had such a state of mind, but I am not willing to give it legal significance in the absence of communication. Thus I do not regard the failure of defendant to except to Finding 29 as conclusive against it. I think it is important to say that my majority colleagues, if I read their minds aright, do think that my position flouts Finding 29. An understanding of this may contribute to the proper future use of this case as a precedent.

In *Goodman* v. *United States*, 182 Ct. Cl. 662, 390 F. 2d 915; *cert. denied* 393 U.S. 824 (1968), the issue was whether certain gains from sales of real estate should be regarded as from property held for sale to customers in the ordinary course of business, under the 1939 Code, or as capital gains. A majority of the court held for the former view, disregarding taxpayers' testimony that they had an investment intent.

in favor of contrary conclusions drawn from surrounding facts and circumstances. There were dissents, but they did not urge that a taxpayer's selfserving testimony as to a previous state of mind should be decisive, and as to this point the court appeared unanimous.

It would seem the *Goodman* evaluation should be *a fortiori* when a taxpayer locks an intent in his breast, manifesting by words or deeds a contrary intent for the edification of the other parties with whom he transacts business. However genuine the secret intent may have been, it is not normally the kind of intent that can be controlling in the administration of the tax laws. If this salutary principle is remembered, the mind can remain open to applying the *Corn Products* doctrine to a stock purchase to secure employment, in a proper case, without giving rise to the evils that concern the defendant.

Troxell and Noall, *cit. supra*, say "It is impossible to predict the outer boundaries of this rapidly expanding concept." (p. 204). "* * * the process of the erosion of traditional concepts of capital assets has not been completed * * *." (p. 207, 208). They urge further judicial refinement and say that "A clarification of the law by the Supreme Court would be appropriate." (p. 208).

Other commentators also call attention to the onesided success of taxpayers in using *Corn Products* for their purposes, contrary to the Supreme Court's apparent belief it was closing a loophole, and urge that a regulation require purchasers of securities to notify the IRS shortly after purchase if they intend to claim the purchase was not for investment. The Yale Law Journal Note, *cit. supra*; Kauffman, *cit. supra*. This has not been done, but without such a regulation the courts should achieve at least part of its purpose by recognizing the sound standard of proof of noninvestment intent here urged.

Statements are commonly made in other branches of tax law that courts cannot rectify tax inequalities by imputing to Congress an unexpressed intent to achieve uniformity and then rewriting what Congress actually put in words, *e.g.*, *Fitch Co.* v. *United States*, 323 U.S. 582, 587 (1945). In *Shakespeare Company* v. *United States*, *post*, at 411, 420, 419 F. 2d 839, 844, the opinion the court adopts as its own says "Courts are powerless to rewrite tax statutes, however

appealing it may be", citing *Fitch*. I joined in that opinion, thinking the statement at least ought to be true, and no doubt generally it is. The branch we are now concerned with is, therefore, somewhat anomalous. The case before us is indeed a hard one and Congress surely should have provided for it. Before we strapped on our armor and leaped on our white horse, however, it seems to me we should have considered. It is not unheard of in framing our opinions, when they are felt to be innovative in approach, to add, even if dictum, a warning that the innovation has limits. *E.g., Sullivan v. United States*, *ante*, at 191, 201, 416 F. 2d 1277, 1293. If the opinion the court today adopts as its own had done this I would not find it as hard to swallow as I do. Instead, it seems only to say that we have put on a good deal of speed already and therefore we should not hesitate to put on more. The innovative nature of the decision proposed is not even recognized as a reason for caution. In dealing with a doctrine commentators already seem to regard as open-ended, we should not contribute as we do today to foster that belief. Such strictures should warn us the time has come to think again about that departure point, now long forgotten, the language used by Congress, to determine our bearings and distance with respect to it, and to plot a course having what all courses ought to have, a destination.

This view of the case makes it unnecessary to determine whether the agency, as it was or as plaintiff thought it was, constituted the kind of "long-term (capital) right" visualized in Freeman's commentary. Also, it is unnecessary to determine whether to obtain ordinary loss treatment, plaintiff is required to show it intended to dispose of the stock at a definite or ascertainable future date, a point much debated by counsel herein, or any other ground on which it could be said that the transaction here was not entitled to be called an ordinary loss.

I would hold, therefore, that plaintiff has failed, as a matter of ultimate fact, to prove that it purchased the involved corporate stock as a business expense rather than as an investment.

Findings of Fact

1. Prior to May 1, 1958, there existed G. H. Waterman & Company, which had been organized in 1940 by Mr. George

H. Waterman, Jr., of Providence, Rhode Island. The company was in the business of selling yarns on commission, primarily for the Carlton Yarn Mills of Cherryville, North Carolina. Waterman had sold yarns since 1931. Although he had sold almost every type of spun yarn, cotton yarn represented the bulk of his sales.

2. Prior to May 1, 1958, there also existed Edward H. Largen & Company, Inc., which had been organized by Mr. Edward H. Largen, Jr., of Charlotte, North Carolina. The company was also in the business of selling yarns on commission, primarily the new synthetic fibers, including dacron and orlon.

3. Prior to May 1, 1958, there also existed Merrill & Company, which had been organized by Mr. Kenneth M. Merrill of New York City. The company was also in the business of selling yarns on commission, principally worsted yarns. Merrill had been vice president in charge of sales for the Whitman Yarn Company, one of the largest spinners of worsted yarns in the country. Thereafter he served as vice president in charge of sales for the Abbott Worsted Company in Massachusetts until it went out of business in 1956. In the latter part of 1956 Merrill, with the financial assistance of Largen and Waterman, formed his own yarn sales company.

4. At this time there also existed the Elmvale Worsted Company (hereinafter sometimes called "Elmvale"), a Massachusetts corporation engaged in the manufacture and sale of worsted wool yarns at Pittsfield, Massachusetts. This 50-year-old company had one of the finest reputations in the country as a quality yarn producer. Mr. Carey R. Kinney was the dominating force behind this company. He was its president and owned 83 percent of the company's stock, the other 17 percent being owned by one Walter M. Cooper. Mr. Kinney's son, Carey T. Kinney (also known, and hereinafter referred to as "Prid Kinney"), had been employed by the company since 1940. He had worked in various capacities throughout the mill, including the production, management, and financing phases of the operation. He was elected assistant treasurer in August 1955, a position he held until the end of 1956, when he was elected treasurer. He served in that capacity until the corporation ceased operations in 1959.

5. Until the summer of 1957 Elmvale manufactured primarily worsted weaving yarns. A very small percentage (less

than one half of one percent) of the production consisted of knitting yarns. All sales of the company's yarns were made by its employees, primarily by Francis-Foxcroft.

6. In 1957 Elmvale was an unprofitable operation. Merrill and Carey R. Kinney had been personal and business friends for many years. In the summer of 1957, Carey R. Kinney asked Merrill to undertake a pilot experiment whereby Elmvale would increase substantially its more profitable knitting yarn manufacturing operations in an effort to turn its unprofitable business into a profitable one. Merrill agreed to have his company undertake the project in return for the customary two percent commission on such sales as it would effect.

7. Merrill met with some success in promoting the sale of Elmvale's knitting yarns. By 1958 the Elmvale knitting yarns sold by Merrill amounted to between one fourth and one-third of its total production.

8. Prior to May 1, 1958, Waterman, Merrill, and Largen decided to join forces and to organize a new corporation, which is the plaintiff herein. Plaintiff was incorporated on May 1, 1958, as Waterman, Merrill, Largen & Company, Inc. It is a corporation in good standing under the laws of the State of Rhode Island with its principal office in Providence, Rhode Island. The idea behind the organization of plaintiff was that Merrill, with his background in the sale of worsted yarns, Waterman, with his background in the sale of cotton yarns, and Largen, with his background in the sale of synthetic yarns, all operating as a single selling agency, would be able to offer a well-rounded line of yarns, which is considered highly desirable in the industry. The ability to offer a broad range of yarns is advantageous because a yarn salesman who can sell a customer one type of yarn can frequently discover uses for other types of yarns and thereby make additional sales. Mr. Ben Rudisill, president of Carlton Yarn Mills, which had been one of the principal accounts of both Waterman and Largen, also urged the formation of plaintiff as a possible means of increasing the sale of Carlton yarns, principally through a strengthened New York office. Waterman and Largen, as a result of the financial assistance they had previously given Merrill, were stockholders in Merrill's company. They had not had connections in the worsted yarn field and were interested in helping Merrill, who was highly

regarded in the worsted industry, develop such a worsted business with the thought that sometime in the future the three might join in one company offering a broad range of yarns.

9. Plaintiff, after incorporation, had offices in Providence, Rhode Island, New York City, Charlotte, North Carolina, and Greensboro, North Carolina. Waterman was in charge of the Providence office, Merrill, the New York office, and Largen, the two North Carolina offices.

10. When plaintiff was incorporated, Waterman was elected president and Largen and Merrill became executive vice presidents. There were two classes of stock, *i.e.*, Class A voting stock, of which Waterman owned 40 percent and Largen and Merrill each owned 30 percent, and Class B nonvoting stock which was owned by their wives, as well as by one Maxwell Heyman, who had also been a stockholder in, and an employee of, Merrill's company. The stockholders' equity in the corporation at that time amounted to $1,100.

11. After incorporation plaintiff was solely engaged in the business of acting as selling agent for various yarn mills in return for a two percent commission. There are other yarn houses which are direct competitors of plaintiff, all of which operate the same way, *i.e.*, on a two percent commission basis.

12. (a) When organized, plaintiff took over the account which Merrill & Company had with Elmvale on the same two percent commission arrangement. As had Merrill, plaintiff continued to sell Elmvale's entire production of knitting yarns. Plaintiff (as had Merrill) also sold a small amount of Elmvale's weaving yarns. Foxcroft, as an employee of Elmvale, continued to sell only Elmvale's weaving yarns.

(b) Plaintiff's principal accounts were various divisions of Carlton Yarn Mills in Salisbury and Cherryville, North Carolina (an $8,000,000—$10,000,000 sales account), the Firestone Textile Division in Gastonia, North Carolina (a $1,800,000 sales account), and Elmvale.

13. From the date of plaintiff's incorporation on May 1, 1958, through the balance of that year, plaintiff earned commissions on the sale of Elmvale's yarns in the amount of $13,720.14. However, by early December, plaintiff's sales of Elmvale's knitting yarns were increasing to the point where its commissions therefrom were being earned at the rate of about $2,000 a month (constituting it a $1,200,000 sales ac-

count). Since the trend of such sales was upward, it was reasonably expected that the sales of knitting yarns and the resulting commissions would continue to increase.

14. Despite the increase in its worsted knitting yarn business, Elmvale still continued, on an overall basis, to be an unprofitable operation, and, around early December 1958, it decided to terminate its textile manufacturing operations. Factors contributing to unprofitability included the antiquated condition of a substantial part of its machinery and the labor conditions in Massachusetts. At that time plaintiff too had been operating at a loss. As of December 31, 1958, plaintiff had, on the basis of its operations since May 1, 1958, an operating loss of $17,345.51. It had assets of $30,825.59 and current liabilities of $47,071.10. The year 1958 was a poor one in the textile industry.

15. The loss of the Elmvale account was a severe blow to plaintiff. The account was an important segment of its worsted sales operation and was the only substantial worsted wool account plaintiff had. Merrill and Heyman were the two employees of plaintiff who were engaged in selling the Elmvale yarns. Merrill's salary was $30,000 per annum and Heyman's approximately $15,000. Both were located in the New York office, and, although Merrill and Heyman also handled the sales of worsted yarns of other mills, including between $1,500,000 and $2,000,000 of turbo-orlon yarns for plaintiff's largest client, Carlton Yarn Mills, the commissions from the Elmvale account contributed significantly toward defraying the overhead expenses, including the salaries, of such office. In addition, Mr. John Busher was an employee working out of the New York office. Besides selling synthetic fiber for Carlton Yarn Mills and cotton yarn for Firestone, he sold some worsted yarn spun from synthetic fibers by the Turbo-Orlon Division of Carlton, which yarn was sold to the same trade as the wool worsted yarns produced by Elmvale, and part of his salary was carried by plaintiff's worsted division. Busher had formerly been a Waterman employee selling Carlton synthetic yarns and Firestone cotton yarns, and was highly regarded by Carlton. He had a one-year contract to May 1, 1959, at a salary of approximately $20,000 per annum. It was hoped that the developing Elmvale account would contribute substantially to the liquidation of plaintiff's operating deficit. When Elm-

vale's decision to terminate its operations was learned by plaintiff, Merrill promptly and diligently attempted to obtain another worsted mill account, but was unable to do so, such accounts being extremely difficult to secure.

16. Merrill, because of his longtime friendship with Carey Kinney, knew of the latter's desire to insure a business future for his son. In addition, the continuance in some form of Elmvale's business and the generation therefrom of commissions for plaintiff were important to plaintiff's business future, especially considering plaintiff's then dire financial straits. Accordingly, Merrill approached Carey Kinney to ascertain if he would be interested in continuing the Elmvale operation in some form but at another location. The difficulties that woolen mills had in operating in New England were well known at the time, and Merrill inquired whether Kinney would be disposed to continue operations if Merrill would be able to locate another mill elsewhere which would be satisfactory to Kinney. Principally because of his desire to perpetuate the Elmvale spinning business for his son, Carey Kinney's reaction to the suggestion was that he would give such a proposal every consideration. Carey Kinney's rejection was then promptly communicated by Merrill to Waterman and Largen.

17. Shortly thereafter, in December 1958, Largen learned from a friend, Mr. Frank Farnell of Charlotte, North Carolina, that the worsted wool yarn spinning mill belonging to the Woonsocket-Laurens Corporation at Laurens, South Carolina, was for sale. This mill made substantially the same type of yarns as Elmvale. Largen immediately notified Waterman and Merrill, who, in turn, so advised the Kinneys.

18. (a) Carey Kinney decided to investigate the Laurens mill situation. Accordingly, around the first week in January 1959, Brud Kinney and Merrill went to South Carolina, where they were joined by Largen, and the three made an inspection of the Laurens plant. Shortly thereafter, also in January, Carey Kinney too made a brief inspection of the plant.

(b) In January 1959 plaintiff, to reduce the overhead of its New York office, effected a termination of Busher's services for a settlement, with payments running through March 1959.

19. (a) The preliminary inspections of the plant were sufficiently favorable, in the Kinneys' opinion, to warrant a further and more detailed survey. Accordingly, early in February 1959, Brud Kinney and the assistant production superintendent at Elmvale, Mr. Joseph Augeri, made a thorough inspection (approximately an entire week) of the Laurens operation, after which they submitted a favorable report of their findings to Carey Kinney, plaintiff, and Mr. Arthur Wellman of the Nichols Fiber Company of Boston, Massachusetts. This company was the largest raw materials manufacturer for the wool yarn industry. Carey Kinney and Wellman had had business relations for many years and Wellman was familiar with the Elmvale operation. Elmvale had purchased substantially all of its raw material from Nichols Fiber. During this period Kinney and Wellman had been holding general discussions looking toward a possible business combine of Elmvale with several other mills. In addition, Kinney had a separate dye works operation and was at the time considering moving such works south.

(b) Elmvale ceased operations at the end of February 1959.

20. The Crompton-Richmond Company, Inc., was Elmvale's factor. It too was interested, and had a financial stake, in the continuance of the Elmvale operation. A number of meetings were held in the Crompton-Richmond offices, attended by Crompton officials, the Kinneys, and plaintiff's principals, concerning the possible purchase of the Laurens plant. Finally, at one of these meetings, attended by Waterman, Merrill, Carey Kinney, and Harris Bucklin and Arthur Corkery, both of Crompton-Richmond, Carey Kinney stated that he was definitely interested in purchasing the Laurens operation. With respect to the part that plaintiff would play in such operation, however, he stated that he would not permit plaintiff to act as commission agent therefor unless plaintiff purchased $100,000 worth of the stock that would be issued in connection with the setting up of the new corporation. For such $100,000 participation, however, he would permit plaintiff to become the exclusive selling agent for the Laurens operation. It was Carey Kinney's business philosophy that a commission agent should have a substantial interest in the mill for which he was selling so that the mill and agent would work together in the nature of a joint venture.

He felt that such an agent would have the incentive not only to sell more intensively but also to perform in better fashion in so far as the quality and nature of the sales were concerned. So called "poor selling," including sales to financially weak companies, had caused many mills to fail. Although Carey Kinney's general business philosophy in this respect was of long standing and was well known to plaintiff's principals, it had not been definitely stated as specifically applying to the prospective Laurens operation until this particular meeting. Brad Kinney was not present at this meeting.

21. Thereafter plaintiff's principals met to consider plaintiff's future course. Plaintiff did not have $100,000. Instead it was, as hereinabove indicated, in serious financial condition. Nor did plaintiff's principals have such an amount. They had made personal loans to plaintiff to keep it going. In view of the overhead being incurred with respect to its worsted activities, including the salaries of its worsted yarn salesmen, and in view of the impossibility of securing another worsted wool account, it was determined that plaintiff would either have to attempt to secure the Laurens account or to liquidate or otherwise drastically reorganize its business. It was finally concluded that plaintiff should, in an effort to continue as a business entity in its then form, attempt to raise $100,000 in order to obtain the Laurens account. It was anticipated, on the basis of the following calculations, that if plaintiff were able to borrow the $100,000, such loan could be repaid in two or three years. The Laurens plant was producing approximately 20,000 pounds of yarn a week and was about breaking even financially. It was the Kinneys' reasonable hope that this production could be increased (by moving some of the newer Whitfield equipment to Laurens) to approximately 50,000 pounds a week. At an average price of two dollars a pound, Laurens' annual sales would be approximately $3,000,000 (50,000 pounds per week multiplied by 50 weeks equals 2,500,000 pounds per year, which, at an average price of two dollars per pound, equals $5,000,000). At the customary two percent commission, plaintiff's annual commissions from this account would thus total approximately $60,000. While the $60,000 per annum would not all represent profit, since substantial selling expenses would have to be allocated thereto, it was nevertheless reasonably felt that with commissions from the Laurens account coming in at such rate, the $100,000

indebtedness could be readily liquidated within such two-to-three year period.

It was known that Carey-Kinney, for various reasons (principally age), would not move south to take an active part in the new operation. It was proposed, however, to have Brud Kinney, as president of the new corporation, move south, as well as Augeri, who would take charge of the production activities. Both were considered to be experienced men in the industry. In addition, Carey Kinney was to be chairman of the board of directors of the new corporation so that his advice and guidance would be constantly available. It was not considered necessary to bring any additional personnel from Pittsfield to produce the same quality product which had been produced at Pittsfield. It was also determined that the new corporation would sell under the Elmvale name, would make substantially the same products as Elmvale had, and would seek to sell to substantially the same customers. Although the times were not propitious for wool worsted mills to increase their business as a growth industry (1959 was also a poor year and foreign imports constituted a serious competitive threat) it was nevertheless reasonably expected that the new corporation would at least be able to continue to break even. A continuation of operations on such a basis would, nevertheless, enable it to generate commissions to plaintiff at such rate of approximately $60,000 a year.

22. Bucklin was the Crompton-Richmond official who was chiefly concerned with the problem of the prospective purchase of the Laurens mill. At one of the meetings in Crompton-Richmond's office Bucklin had offered to lend Carey Kinney $100,000 to aid in setting up the new corporation, which offer, however, Kinney did not accept. Accordingly, plaintiff's principals decided to approach Bucklin to ascertain whether Crompton-Richmond would lend plaintiff the $100,000 for the purchase of the stock in the proposed new corporation so that plaintiff could meet the condition which Carey Kinney had imposed for its continuance as selling agent. In early March 1959 Waterman discussed the matter with Bucklin. After considering the prospects of the new corporation and the calculations as set forth above, Bucklin assured Waterman that Crompton-Richmond would lend plaintiff the $100,000 for such purpose. Plaintiff's principals thereupon advised the Kinney interests that they would be willing to

put $100,000 in the proposed corporation provided plaintiff would be designated as its exclusive selling agent.

23. Kinney, upon being advised by plaintiff of its willingness to purchase $100,000 worth of stock in the new corporation, then proceeded to work out the further details, and a final agreement was reached on May 18, 1959. The parties thereto were, Elmvale, plaintiff, the Woonsocket-Laurens Corporation, and Edwin and Frank Farnell, who were minority stockholders in the Laurens mill. Since the Kinneys desired to perpetuate the Elmvale name and to retain as many of the old customers as possible, it was agreed that all the textile assets and liabilities of the Laurens corporation would be turned over to a new corporation called the Elmvale Worsted Company, Inc. (the identical name of the Pittsfield company with only the "Inc." added, and hereinafter referred to as Elmvale-Laurens), which new corporation was to be formed on May 25, 1959, and with operations to commence fourteen days thereafter, *i.e.*, on June 8, 1959. Plaintiff was to put up $100,000 for 1,000 shares; the Kinneys were to put up $100,000 plus $35,000 worth of equipment (to be moved from Pittsfield, Massachusetts) for 1,350 shares; the Nichols Fiber Company was to put up $50,000 for 500 shares; and the Farnells were to receive 150 shares in return for the stock they held in the Laurens corporation. The agreement was carried out in this form with the new corporation being organized on May 25, 1959. However, the 1,350 Kinney shares were actually issued to the Kinney Worsted Yarn Company, a 100 percent owned subsidiary of Elmvale. The new corporation's operations commenced on June 8, 1959.

24. In order to purchase the 1,000 shares, plaintiff borrowed the $100,000 at 6 percent per annum from Crompton-Richmond, the stock constituting collateral for the loan. In addition, the note evidencing the indebtedness was personally endorsed by plaintiff's three principals.

25. As was the understanding between all interested parties, plaintiff became the exclusive selling agent for Elmvale-Laurens. Plaintiff was paid a commission at the rate of two percent of the net amount of these sales. Crompton-Richmond continued as the factor of Elmvale-Laurens. The factor paid plaintiff's commissions monthly out of the proceeds of the Elmvale-Laurens sales and charged the commission pay-

ment to the factoring account. This arrangement was confirmed in its letter to Elmvale-Laurens, dated May 29, 1959, and endorsed as agreed to by Elmvale-Laurens and plaintiff.

26. The exclusive representation by plaintiff of Elmvale-Laurens was announced to the trade on or about June 15, 1959.

27. The employees at the former Laurens operation were continued as employees of Elmvale-Laurens. Brud Kinney became president of Elmvale-Laurens, and Augeri its production head. Both moved to Laurens, South Carolina. Carey Kinney became chairman of its board of directors, with Brud Kinney also being on the board.

28. Because of the economic situation affecting the worsted yarn industry at the time of the organization of Elmvale-Laurens, none of the principals of plaintiff expected the stock to appreciate in value to any substantial degree or that the company would be in a position to declare dividends over the years. Their sole expectation was that the company would continue to operate at substantially full capacity for an indefinite number of years on probably a break-even basis with plaintiff securing approximately $60,000 per year in commissions on the sale of Elmvale-Laurens yarns.

29. Plaintiff did not borrow the $100,000 from Crompton-Richmond Company and put it into Elmvale-Laurens as an investment in the sense of looking to future stock appreciation or dividends as a return on capital. The sole purpose of borrowing the money and putting it into the stock of Elmvale-Laurens was to regain an important selling agency arrangement and thereby replace the commissions lost from Elmvale-Pittsfield. However, the hoped for commissions of approximately $60,000 a year would produce greater annual commissions than plaintiff had obtained from the former Elmvale operation, which, as shown, amounted to approximately $2,000 a month or $24,000 per annum at the time Elmvale ceased operations, although the rate of such commissions was steadily increasing. The commission differential was at least in part attributable to the fact that plaintiff had not been Elmvale's exclusive selling agent, that company itself having sold substantially all of its own weaving yarns which constituted the largest part of its production. At Elmvale-Laurens the arrangement was for plaintiff to sell the

mill's entire production. It was, however, a business necessity for plaintiff to borrow the $100,000 and put it into the stock of Elmvale-Laurens in order to continue to exist at all, or at least to exist in its then corporate form, *i.e.*, with a worsted wool division.

30. Every effort was made to demonstrate to the customers of Elmvale-Laurens that the same management, the same selling agent, and the same products and quality were being offered under the Elmvale name as had been offered at the Pittsfield plant. In addition to plaintiff's principals, Brud Kinney himself called on former customers, and in so effecting sales, he acted in the capacity of an employee of plaintiff, for which he received a salary of $10,000 per annum. Elmvale-Laurens was able to continue selling yarns to most of the former Elmvale customers.

31. From the outset Elmvale-Laurens experienced many difficulties and as a result it suffered operating losses. Friction developed between the mill production personnel and Merrill and Heyman in the New York office, who were (in addition to Brud Kinney) plaintiff's employees principally engaged in the selling of the mill's worsted products. Among other things, Elmvale-Laurens felt plaintiff was not obtaining the best possible prices for the mill's products, while plaintiff felt the company was unrealistic. Further, plaintiff complained about the poor quality of yarn being produced, with large quantities being rejected by customers.

32. The financial state of Elmvale-Laurens in September 1960 was extremely poor, the company having lost a considerable amount of money. Steps were taken to rectify the situation. As of October 1, 1960, Brud Kinney agreed to cut his salary in half and plaintiff agreed to cut its commission temporarily from two percent to one percent. However, plaintiff could not operate profitably on this reduced commission, and the two percent commission rate was restored on January 1, 1961.

33. For the part of the year 1959 during which Elmvale-Laurens operated, plaintiff earned commissions in the amount of $9,400. In 1960 its commissions totaled approximately $29,000. Because Elmvale-Laurens' sales did not rise to plaintiff's original expectation, the commissions earned from the sale of Elmvale-Laurens yarn were not sufficient to pay the

installments due on the $100,000 indebtedness to Crompton-Richmond in accordance with the original schedule of payments specified in the note evidencing the indebtedness. Plaintiff was finally able to pay the note in full in 1964.

31. By February 28, 1961, Elmvale-Laurens had a deficit working capital of approximately $150,000 and was in very poor financial condition. At that point friction between Brud Kinney and Heyman and Merrill was such that it was not feasible for Heyman and Merrill to continue selling Elmvale yarn. Plaintiff's financial status was also extremely precarious. It could not borrow money through normal channels and was forced to borrow $25,000 from the Carlton Yarn Mills to continue operating. In May 1960 plaintiff had lost an important account (Firestone Textiles, Firestone having terminated its yarn manufacturing business) from which plaintiff had earned approximately $100,000 annually in commissions. As a result, plaintiff had reduced the number of its employees (none of the terminated employees, however, being shareholders in plaintiff, as were Merrill and Heyman). Plaintiff was not able to replace this account although it attempted diligently to do so.

35. Because Merrill and Heyman could no longer feasibly sell Elmvale-Laurens yarns for plaintiff, an amicable agreement was reached whereby their stock was redeemed, Merrill was relieved of his personal obligation on the Crompton-Richmond note, and they resigned as employees of plaintiff effective February 28, 1961. On that date the corporation's name was changed to Waterman, Largen & Company, Inc. (Since that date all of plaintiff's stock is owned by Mr. and Mrs. Waterman and Mr. and Mrs. Largen.)

36. Plaintiff then employed a Mr. Paul Barker to sell Elmvale-Laurens yarns and made arrangements with another organization in the west to help sell the product. While Brud Kinney was satisfied with the new arrangement, the sales situation still did not improve and the financial status of Elmvale-Laurens continued to deteriorate.

37. Largen was on Elmvale-Laurens' board of directors representing plaintiff's interests, including its agency agreement. Plaintiff had no representative who was an officer or employee of Elmvale-Laurens.

38. From approximately October 1960 Elmvale-Laurens was able to continue operations only because of the credit

which was extended to it by the Nichols Fiber Company. By May 1961 Wellman of the Nichols Fiber Company concluded that it would be advisable for another company to participate in the sales of the Elmvale yarns. On May 12, 1961, Wellman wrote a letter to Mr. John Stickley of John L. Stickley & Company, one of plaintiff's competitors (with a copy to Brud Kinney at Elmvale-Laurens and to plaintiff) to the effect that he felt it would be advisable for Mr. Stickley to take over certain of the accounts of Elmvale-Laurens. Such accounts thereupon were transferred to Stickley. Thus plaintiff no longer was Elmvale-Laurens' exclusive selling agency.

39. (a) On June 22, 1961, Elmvale-Laurens addressed a letter to plaintiff stating that plaintiff's yarn selling agency was terminated effective June 30, 1961. Plaintiff's principals did not believe that the exclusive sales agency agreement between plaintiff and Elmvale-Laurens was so terminable at the will of the mill, and they considered legal proceedings. In the industry, selling agency arrangements are generally based on oral agreements and are normally considered to be terminable at will by the mill upon ninety days' notice. However, plaintiff felt that its particular arrangement, supported by a $100,000 purchase of stock under an agreement which it construed as entitling it to an exclusive agency as long as it held the stock and gave satisfactory service (which it thought it was rendering), did not permit such a termination. Plaintiff concluded, however, that even if such proceedings were successful, Elmvale-Laurens could not respond to any substantial judgment. As of March 31, 1961, it had a working capital deficit of around $160,000. Were Wellman to terminate the credit he had extended, Elmvale-Laurens would, in any event, be obliged to terminate operations. It was decided, therefore, that the expense of instituting and conducting such a suit would not be justified.

(b) Plaintiff earned commissions in the amount of approximately $13,500 from Elmvale-Laurens during the part of 1961 in which it acted as its sales agent.

(c) Approximately half of the commissions which plaintiff earned from Elmvale-Laurens during the years 1959, 1960, and 1961 were derived from sales of knitting yarns, the balance of the commissions being from sales of weaving yarns.

40. Since the only business reason for retaining the stock interest in Elmvale-Laurens was thus terminated, plaintiff immediately took steps to sell the stock. Approaches to several possible buyers were made. However, only one, a Mr. Clifford Brown, of Providence, Rhode Island (who was not a yarn broker), showed any interest.

41. (a) Having received no other offers, plaintiff, on July 21, 1961, sold its 1,000 Elmvale-Laurens shares to Brown for $25,000, resulting in a loss of $75,000. The $25,000 Brown paid for the stock was approximately book value.

(b) Plaintiff had made no prior attempts to sell the stock. It reasonably felt that the retention of the stock was a condition to its continuing to act as Elmvale-Laurens' exclusive selling agent, in accordance with the understanding it had with, and the requirement imposed by, Carey Kinney.

42. During the period plaintiff owned the 1,000 shares of Elmvale-Laurens common stock, plaintiff did not receive any dividends or any other distribution in connection with the stock. The only amounts received by plaintiff from Elmvale-Laurens were commissions from the sale of its yarn.

43. The stock in Elmvale-Laurens was the only stock or security ever bought, owned, or sold by plaintiff.

44. Plaintiff's accountant, Mr. Joseph B. Brown, was solely responsible for recording the purchase of the Elmvale-Laurens stock on the books of plaintiff. At the time of the purchase, Waterman informed Brown that plaintiff had purchased the stock for the purpose of receiving commissions from the sale of the yarns. Brown recorded the purchase in a separate account entitled "Investment in Elmvale."

45. Brown was also responsible for preparing plaintiff's federal income tax return for 1961. In so doing, he recorded the loss on the sale of stock in Elmvale-Laurens as a capital loss. He felt that a loss on the sale of capital stock necessarily constituted a loss on the sale of a capital asset.

46. On September 3, 1963, plaintiff, after becoming aware of certain decided cases permitting the loss on the sale of capital stock to be treated, in certain situations, as an "ordinary" loss, timely filed claims for refund of federal income tax for its taxable years ended December 31, 1961, and December 31, 1962, claiming a deduction for the loss on the sale of the Elmvale-Laurens stock in the amount of $75,000 as an

ordinary loss in the year of sale, 1961, and for a net operating loss carryover deduction for the year ended December 31, 1962.

47. More than six months has elapsed since the claims for refund were filed and no refunds have been made by defendant to plaintiff. No action on the said claims for refund, other than that described heretofore, has been taken by plaintiff before the Congress of the United States or before any departments of the government.

48. Plaintiff employs the accrual method of accounting in maintaining its books and records and in filing its federal income tax returns.

49. Plaintiff timely filed its federal income tax returns for the calendar years 1958, 1959, 1960, 1961, and 1962.

50. Plaintiff's federal income tax return for the calendar year 1958 reflected a net operating loss of $17,345.51.

51. Plaintiff's federal income tax return for the calendar year 1959 reflected a taxable income before deducting the net operating loss carryover from the calendar year 1958 of $14,988.84. By reason of the net operating loss carryover from the calendar year 1958 to the calendar year 1959, plaintiff did not pay any tax for the calendar year 1959.

52. Plaintiff's federal income tax return for the calendar year 1960 reflected a taxable income before deducting the net operating loss carryover from the calendar year 1958 of $884.76. By reason of the net operating loss carryover from the calendar year 1958 to the calendar year 1960, plaintiff did not pay any tax for the calendar year 1960.

53. Plaintiff's federal income tax return for the calendar year 1961 reflected a taxable income before deducting the net operating loss carryover from the calendar year 1958 of $20,877.68. By reason of the net operating loss carryover from the calendar year 1958, plaintiff reduced its taxable income for the calendar year 1961 to $19,405.77 and paid to the District Director of Internal Revenue, Providence, Rhode Island, income tax in the amount of $5,821.73.

54. Plaintiff's federal income tax return for the calendar year 1962 reflected thereon taxable income of $23,787.96. Plaintiff paid the District Director of Internal Revenue, Providence, Rhode Island, income tax thereon in the amount of $7,136.39.

55. Plaintiff's gross commissions, during the years 1958 through 1962, from the sale of various types of yarn were as follows:

Year:	Amount
1958	$200,537.80
1959	311,563.76
1960	274,993.39
1961	213,267.59
1962	201,017.52

Conclusion of Law

Upon the foregoing findings of fact and opinion, which are adopted by the court and made a part of the judgment herein, the court concludes as a matter of law that plaintiff is entitled to recover. The amount of the recovery will be determined in subsequent proceedings under Rule 131(c).

APPENDIX B

In the United States Court of Claims

No. 14-65

WATERMAN, LARSEN & CO., INC.

v.

THE UNITED STATES

ORDER

On November 14, 1969, the court rendered an opinion holding that the plaintiff was entitled to recover and entering judgment to that effect. The determination of the amount of recovery was reserved pending further proceedings pursuant to Rule 131(c).

On February 27, 1970, the commissioner of this court filed a memorandum report recommending that, in accordance with the opinion of the court and the stipulation of the parties, judgment be entered for the plaintiff in the sum of $12,958.12, together with interest as provided by law, which recommendation is adopted by this court.

It is therefore ordered, that judgment be and the same is entered for the plaintiff in the sum of twelve thousand nine hundred fifty-eight dollars and twelve cents ($12,958.12) together with interest as provided by law.

By the Court,

WILSON COWEN,
Chief Judge.

Filed
MARCH 6, 1970.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 415

UNITED STATES OF AMERICA, *Petitioner,*

v.

WATERMAN, LARGEN & CO., INC., *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Claims

BRIEF FOR THE RESPONDENT IN OPPOSITION

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 415

UNITED STATES OF AMERICA, *Petitioner*,

v.

WATERMAN, LARGEN & CO., INC., *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Claims

---

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW AND JURISDICTION

The opinions below and the basis of this Court's jurisdiction are adequately set forth in the petition.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 162. TRADE OR BUSINESS EXPENSES.

(a). IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses

paid or incurred during the taxable year in carrying on any trade or business, including . . .

Sec. 165. Losses.

(a) GENERAL RULE. There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

QUESTION PRESENTED

Whether a loss realized on the sale of stock of a yarn mill purchased and held by a yarn mill broker solely to retain an existing commission account, is an ordinary loss or business expense rather than a capital loss where the stock purchase was a business necessity in order for the broker to continue to exist in its then corporate form.

STATEMENT

Respondent is in the business of selling, on a commission basis, various types of yarn produced by its mill accounts, one account of which was the Elmvale Worsted Company, hereinafter called Elmvale, a Massachusetts corporation located in Pittsfield, Massachusetts. (Pet. App. A51-52)

Elmvale, by the latter part of 1958, had become Respondent's third largest account and the principal factor in the worsted division of its business. Elmvale, however, had found operations unprofitable and in early December, 1958, it decided to terminate operations. (Pet. App. A54-55)

The potential loss of this account was a serious blow to Respondent. Respondent was then operating at

a loss and the Elmvale account was an important segment of its worsted sales operation and was the only substantial worsted wool account Respondent had. (Pet. App. A55-56)

Respondent promptly and diligently attempted to obtain another worsted wool account but did not succeed, since such accounts were extremely difficult to secure. Respondent, knowing that Elmvale's president wished to insure his son's business future, inquired whether he would be interested in continuing in business if some other satisfactory mill could be located at a different location. When he replied that such a possibility would be given every consideration, Respondent went out and located a suitable mill in Laurens, South Carolina. (Pet. App. A55-56)

After investigating and inspecting this new plant site, Elmvale's president disclosed his willingness to become the dominant shareholder in a new corporation to be organized to take over the assets of the Laurens plant. (Pet. App. A57)

Some meetings were held to discuss the possibilities of reopening in South Carolina and at one of these meetings Respondent's role in connection with the new organization was discussed. Elmvale's president stated that Respondent would not be permitted to act as Elmvale's commission agent unless Respondent purchased $100,000 worth of stock that would be issued in connection with the setting up of the new corporation. For such $100,000 participation, however, it would become the exclusive selling agent for the Laurens operation. (Pet. App. A57-58)

In view of the impossibility of securing another worsted wool account, Respondent's officers determined

that they would either have to attempt to secure the Laurens account or to liquidate or otherwise drastically reorganize their business. They finally concluded that Respondent should, in an effort to continue as a business entity in its then form, attempt to raise $100,000 in order to obtain the Laurens account. (Pet. App. A58-59)

After arranging to borrow the necessary funds, Respondent's officers advised the Elmvale president that they would be willing to put $100,000 in the proposed corporation, provided they would be designated as its exclusive selling agency (Pet. App. A59-60)

Further details were worked out and a final agreement was reached in May, 1959. (Pet. App. A60)

Respondent did not put the $100,000 into Elmvale as an investment in the sense of looking to future stock appreciation or dividends as a return on capital. The sole purpose of borrowing the money and putting it into the stock of Elmvale was to regain an important selling agency arrangement and therefore replace the commissions lost from the (old Massachusetts) Elmvale corporation. It was anticipated that the expected commissions would result in the profitable operation of Waterman, Largen's worsted wool division and would permit repayment of the loan within two or three years (Pet. App. A58-59, 61-62)

Respondent received $51,900 in commissions from Elmvale between May, 1959, and June, 1961. (Pet. App. A62-64)

Elmvale's operations continued to be unprofitable even in the new location, however, and by May of 1961, an Elmvale financier required Elmvale to appoint

a competitor of Respondent as sales agent, thereby discontinuing Respondent as exclusive sales agent. On June 22, 1961, Respondent's sales agency with Elmvale was completely terminated effective June 30, 1961. (Pet. App. A63-64)

Since the only business reason for retaining the stock interest in Elmvale was thus terminated, Respondent immediately took steps to sell the stock. On July 21, 1961, Respondent sold its shares for $25,000, resulting in a loss of $75,000. (Pet. App. A65)

ARGUMENT

The taxpayer, Waterman, Largen & Co., Inc., opposes the Petition for Writ of Certiorari in this case because there is no conflict among the Courts of Appeals or the Court of Claims on the issue presented and certainly no question of substantial legal importance which has not previously been resolved by this Court.

1. The issue in this case is whether a loss on the sale of stock purchased to acquire or insure a source of everyday business requirements (in this case sales commissions obtained through an exclusive sales contract) is an ordinary loss or a capital loss. This issue is governed by the principle set forth in the decision of this Court in *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955). That principle can be stated to be that, even though the literal language of the definition of a capital asset[1] may be met, Congress intended that profits and losses arising from the everyday operation of a business should be considered as

[1] Section 1221, Internal Revenue Code of 1954.

ordinary income or loss rather than capital gain or loss. It would appear that this principle directly contradicts the contention made in the Petition (pp. 8-9) that the language "(whether or not connected with his trade or business)" in the definition of a capital asset requires capital loss treatment.

During the fifteen years since the *Corn Products*, *supra*, decision, this specific issue has come before the Tax Court,[2] a number of District Courts,[3] four U.S. Courts of Appeals,[4] and the Court of Claims.[5] No conflict has developed. The lower court decisions have applied the principle announced in *Corn Products*, *supra*, to a myriad of factual situations with no greater difficulty than is encountered in the normal judicial process of applying governing legal principles to a variety of factual situations. In addition, the cases have not been uniformly favorable to the taxpayer. The Government has succeeded in denying ordinary

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[2] See, *e.g.*, *Western Wine & Liquor Co.* v. *Commissioner*, 18 T.C. 1090, acq. 1958-2 C.B. 8; *Electrical Fittings Corp.* v. *Commissioner*, 33 T.C. 1026; *Livesley* v. *Commissioner*, 19 T.C.M. 133; *Old Dominion Plywood Corp.* v. *Commissioner*, 25 T.C.M. 678; *Southeastern Aviation Underwriters, Inc.* v. *Commissioner*, 25 T.C.M. 412.

[3] See, *e.g.*, *Journal Co.* v. *United States*, 195 F. Supp. 434; *Hogg* v. *Allen*, 105 F. Supp. 12; *Hagan* v. *United States*, 221 F. Supp. 248.

[4] *Commissioner* v. *Bagley & Sewall Co.*, 221 F.2d 944 (2d Cir.); *Edwards* v. *Hogg*, 214 F.2d 640 (5th Cir.); *Grier, John J., Co.* v. *United States*, 328 F.2d 163 (7th Cir.); *Steadman* v. *Commissioner*, 424 F.2d 1 (6th Cir.).

[5] *Booth Newspapers, Inc.* v. *United States*, 157 Ct. Cl. 886, 303 F.2d 916; *F. S. Services, Inc.* v. *United States*, 188 Ct. Cl. 874, 413 F.2d 548.

loss treatment[6] and in imposing ordinary income treatment[7] under the *Corn Products* principle.

Given the governing principle set forth in *Corn Products, supra*, as well as in *Hort* v. *Commissioner*, 313 U.S. 28, and *Commissioner of Internal Revenue* v. *P. G. Lake, Inc.*, 356 U.S. 260, limiting the definition of a capital asset to exclude items which are essentially an element of ordinary income, the application of this principle to the numerous factual situations in which the issue arises must necessarily be left to the trier of fact. The issue is essentially a factual issue.[8] As this Court stated in *Corn Products, supra*, at page 51:

> "For tax purposes Petitioner's purchases have been found to 'constitute an integral part of its manufacturing business' by both the Tax Court and the Court of Appeals, and *on essentially factual questions* the findings of two courts should not ordinarily be disturbed." [Emphasis added].

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[6] See *Gulftex Drug Co.* v. *Commissioner*, 29 T.C. 118, aff'd *per curiam* 261 F.2d 238; *Missisquoi Corp.* v. *Commissioner*, 37 T.C. 791; *Chase Candy Co.* v. *United States*, 130 Ct. Cl. 102, 126 F. Supp. 521; *Duffey* v. *Lethert*, 63-1 U.S.T.C. ¶ 9442.

[7] See, *e.g.*, *Mansfield Journal Co.* v. *Commissioner*, 274 F.2d 284; *Pierce, S.S., Co.* v. *United States*, 57-2 U.S.T.C. ¶ 9886; *Hollywood Baseball Association* v. *Commissioner*, 423 F.2d 494 (9th Cir. 1970), cert. applied for May 14, 1970.

[8] Here, the facts show that the taxpayer was a commission sales agent of yarn. The Court of Claims found that the sole purpose of purchasing the stock in question was to regain an important yarn sales agency arrangement it would otherwise have lost. The taxpayer succeeded in regaining the agency arrangement and earned $51,900 in commissions during the two-year period the arrangement endured. After the arrangement was terminated, the taxpayer sold the stock it was required to purchase to obtain the sales agency agreement. It incurred a loss of $75,000 on such sale.

The Opinion of the Commissioner of the Court of Claims, adopted by the Court below, found (Pet. App. A33) that:

> "It seems plain that the situation falls within the *Booth Newspapers* principle as '*securities . . . purchased by a taxpayer as an integral and necessary act in the conduct of his business*' . . ." [Emphasis added]

Thus, on the *essentially factual question*, we have the same finding here by both the Commissioner and the Court of Claims as was true in *Corn Products, supra*. Given such findings and this Court's statement in similar circumstances that such findings should not ordinarily be disturbed, grant of the instant Petition would appear to be fruitless.

2. It could be argued that the *Corn Products, supra*, principle is inapplicable to the instant case because *Corn Products, supra*, involved regular purchases and sales, rather than a single transaction. However, the application of the *Corn Products, supra*, principle to a "one shot" purchase of capital stock of a corporation is recognized and accepted by the Petitioner in its Petition (pp. 12-14) as well as by the acquiescence of the Internal Revenue Service in *Western Wine and Liquor, supra* fn. 2, and in Rev. Rul. 58-40, 1958-1 C.B. 275. Further, the Petition does not quarrel with the so-called step-transaction doctrine that if one asset is acquired solely to obtain another, it is deemed that the latter asset has been acquired to determine the tax consequences of the transaction. Thus, in applying this doctrine to the instant case, the character of the tax treatment of the $75,000 loss incurred by the taxpayer turns on the question whether a commission sell-

ing agent can deduct as an ordinary loss the amount paid to obtain an agency contract when that contract is subsequently cancelled. The law is clear that an ordinary loss is to be allowed.[9] On the other hand, had the taxpayer not only earned the commissions but also realized a profit on the sale of the agency contract itself, capital gain would not be allowed on the contract.[10]

The Petition in this case does not ask this Court to overrule the principle set forth in *Corn Products*, *supra*, or to reject the "step transaction" or "look through" doctrine relied upon in *Western Wine and Liquor*, *supra*. Rather, this Court is apparently asked to lay down further rules as to when the *Corn Products*, *supra*, doctrine should be applied. It is submitted that this issue of capital gain or loss arises in a wide variety of differing factual situations which do not lend themselves to detailed rules. The business exigencies which may cause a taxpayer to purchase one asset in order to obtain another asset which is vital or necessary to his everyday business operations do not come in simple, neat, factual packages for which a set of specific rules is appropriate. It is submitted that the governing principles of *Corn Products*, *supra*, and *Western Wine and Liquor*, *supra*, are the proper

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[9] See, *e.g.*, *Robert Templin*, 13 T.C.M. 757 (auto franchise); *Elston Co.* v. *U.S.*, 21 F. Supp. 267 (Ct. Cls. 1937) (liquor license); *Metropolitan Laundry Co.* v. *U.S.*, 100 F. Supp. 803 (customer list); *Meredith Broadcasting Co.* v. *U.S.*, 405 F.2d 1214 (Ct. Cls. 1969) (TV network affiliation contract); Rev. Rul. 57-503, 1957-2 C.B. 139 (goodwill).

[10] See not only *Corn Products*, *supra*, but also *Leonard Hunter* v. *Commissioner*, T.C. Memo 1961-318, aff'd 325 F.2d 715 (5th Cir.), cert. den. 379 U.S. 832; *Maryland Coal & Coke Company* v. *McGinnis*, 350 F.2d 293 (3rd Cir. 1965).

guidelines to be applied by the lower courts. The fact that 15 years after the *Corn Products*, *supra*, decision no conflict among the lower courts has arisen demonstrates this. The three cases presently before this Court on Petitions for Writ of Certiorari[11] all reflect consistent application of the governing principle of *Corn Products*, *supra*, to different factual situations. Rules or restrictions which might be adopted to limit the application of the *Corn Products*, *supra*, principle to a given set of facts will almost certainly give rise to additional problems and further litigation with respect to a different set of facts.

A consistent body of law exists with respect to each aspect of the Government's purported distinctions between *Corn Products*, *supra*, and the instant case, namely, that *Corn Products*, *supra*, involved inventory rather than other assets,[12] that *Corn Products*, *supra*, involved transactions for a temporary period,[13] and that *Corn Products*, *supra*, involved a continuing series of transactions.[14] Any alleged conflict in the decisions is factual, rather than legal, and results from

[11] *Steadman* v. *Commissioner*, *supra* fn. 4; *Hollywood Baseball Association* v. *Commissioner*, *supra* fn. 7; and the instant proceeding.

[12] See *Commissioner* v. *Gillette Motor Transport, Inc.*, 364 U.S. 130; *Hort* v. *Commissioner*, 313 U.S. 28; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260 for denial of capital gain on disposition of noninventory assets.

[13] See *Corn Products*, *supra*, where the taxpayer had a regular practice of purchasing futures to insure a supply of manufacturing requirements and fn. 5 at p. 49 for a five-year history of this practice.

[14] See *Western Wine and Liquor*, *supra*, fn. 2, and Rev. Rul. 58-40 for application of the *Corn Products*, *supra*, principle to a single transaction.

application of consistent legal standards to varying factual situations.[15]

The legal standards applied in these decisions which apply the *Corn Products*, *supra*, principle to the sale or worthlessness of stock are not only consistently applied, they are also virtually identical to the standards applied to determine whether a taxpayer has suffered a "business" bad debt, which is deductible in full in the year of worthlessness under section 166 (a) of the Internal Revenue Code of 1954, or a "nonbusiness" bad debt, which is deductible as a short-term capital loss under section 166(d).[16]

3. If there is any issue of great importance, it would not appear to be a conflict in the lower court decisions but the Government's auditing problem referred to in the Petition (pp. 19-21). Simply put, the Government says a gain on the sale of stock will always be reported as capital gain and, if appropriate, a loss will be reported as an ordinary loss. Apparently, the problem arises because stock is presumed to be a capital asset. However, the taxpayer does not see how

[15] It is analogous to the application of this Court's decisions in *John Kelley Co.* v. *Commissioner*, 326 U.S. 521; *The Donruss Co.* v. *United States*, 393 U.S. 297; or *Malat* v. *Riddell*, 383 U.S. 569, to the numerous factual situations involving, respectively, the question of whether a loan to a corporation should be treated as a valid debt or a contribution to capital, whether a business is unreasonably accumulating its income or whether a particular asset is sold in the ordinary course of trade or business. Certainly the Petitioner would not ask the Court to reexamine its decisions in those cases in light of their application to varied factual situations, yet it is asking for such a reexamination in the instant case.

[16] See *Whipple* v. *Commissioner*, 373 U.S. 193 (1963); *Niblock* v. *Commissioner*, 417 F.2d 1185 (7th Cir. 1969); *Estate of Saperstein*, T.C. Memo 1970-209.

the Government has asked this Court to solve its auditing problem. The Government concedes that under some circumstances a loss incurred on a one-shot sale of stock is entitled to be treated as an ordinary loss. See, *e.g.*, Pet. 12-14, *Western Wine and Liquor*, *supra*, and the Government's acquiescence therein, *supra* fn. 2; Rev. Rul. 58-40, *supra*. However, if in these situations the stock in question had appreciated in value during the period held, the Government would have had exactly the same auditing problem described in the Petition if the taxpayer there had reported the profit as a capital gain. Consequently, the taxpayer fails to see how the auditing problem is a relevant factor before this Court. If there is such an auditing problem, it would appear that if the Internal Revenue Service cannot provide adequate safeguards as they have with respect to entertainment expenses and numerous other subjects [17] and as is proposed on the 1970 return with respect to disclosure of foreign bank accounts,[18] Congress would be the appropriate branch of the Government in which to seek relief.[19]

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[17] See, *e.g.*, Questions G through Q on Corporate Return Form 1120.

[18] See Commissioner of Internal Revenue Thrower's announcement, May 11, 1970. In addition, the Internal Revenue Service does not appear to encounter any auditing difficulties in applying section 265 to disallow deductions incurred to purchase or carry tax-exempt bonds, even though the interest earned on such bonds is not reported by individuals in any way.

[19] In this connection, it might be noted that at no point in the entire legislative history of the recently-enacted Tax Reform Act (primarily enacted to close "loopholes") is there any mention of the "loophole" complained of in the Petition.

CONCLUSION

The Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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August, 1970

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Nos. 415, 416

In the Supreme Court of the United States

OCTOBER TERM, 1970

UNITED STATES OF AMERICA, PETITIONER

v.

WATERMAN, LARSEN & CO., INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES W. AND DOROTHY F. STRADMAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES AND THE COMMISSIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 415

UNITED STATES OF AMERICA, PETITIONER

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES AND THE COMMISSIONER

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1. The briefs in opposition in these cases themselves demonstrate the need for prompt review and correction by this Court.

Respondents concede (Br. (No. 415) 8; Br. (No. 416) 10) that they acquired capital interests in corporations; Waterman, Largen concedes (Br. (No.

404-949—70

415) 5–6) that the Court of Claims' construction of *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, cannot be squared with the language of Section 1221, which says in the plainest terms that the characterization of an asset as capital or non-capital is to be made without regard to whether that asset is connected with the taxpayer's trade or business. It also concedes (Br. (No. 415) 11) that the lower court applied the standards of Section 166, relating to business bad debts, even though that provision has no bearing whatever upon losses on the sale of stock. Steadman concedes (Br. (No. 416) 8–9) that the Sixth Circuit in effect applied the standards of Sections 1231, 1242 and 1244 —standards allowing taxpayers capital treatment on gains and ordinary treatment on losses in carefully delineated circumstances—despite the fact that those provisions admittedly are inapplicable here.

After all these concessions, however, respondents oppose review by this Court. They do so on the ground (Br. (No. 415) 6–8, 10–11; Br. (No. 416) 7–8) that the issue in these cases is factual in nature. But the issue here is whether the capital asset provision—Section 1221—is to be read out of the income tax law in cases where corporate stock

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Steadman asks rhetorically (Br. (No. 416) 8–9) why different rules should apply to his depreciable law books, on the one hand, and stock purchased for a business purpose, on the other. The answer is that Section 1221(2) excepts depreciable property from the definition of a capital asset if it is used in a taxpayer's trade or business; it does not except capital stock from that definition "whether or not connected with his trade or business." In short, Congress has provided one rule for depreciable business property and another for stock.

is acquired for a "business purpose." That is clearly a legal issue.[2] One need read no further than the "Statutes Involved" portions of the briefs in opposition (Br. (No. 415). 1–2; Br. (No. 416) 2–4) to confirm this, for neither respondent has cited Section 1221, which is captioned "CAPITAL ASSET DEFINED." Moreover, there is no dispute as to the salient underlying facts. All that remains for this Court to decide is whether a "business purpose" for a stock acquisition can convert that stock from a capital into a non-capital asset.

2. In No. 415, three business entrepreneurs organized and capitalized the Elmvale-Laurens corporation and owned its capital stock. Each had an interest in a long-term venture; each had a particular reason for investing. Carey Kinney wanted (Pet. (No. 415) App. 28) "to insure his son's business future." Nichols

[2] Respondents point out (Br. (No. 415) 6–7; Br. (No. 416) 8) that, in the past 15 years, there have been a few instances in which lower courts have invoked *Corn Products* in the government's favor. From this, they make the curious and transparently incorrect argument that all purported applications of *Corn Products* must be deemed factual *regardless of the legal standard used*. In addition, in reliance on the same cases, they dispute our contention (Pet. (No. 415) 14–15, 19–20) that the potentially limitless "business purpose" concept, which has come to full fruition in recent years, cannot be applied evenhandedly to taxpayers and the government alike (Br. (No. 415) 6–7; Br. (No. 416) 8). But, in this regard, respondents fail to cite a single case other than *Hollywood Baseball Association* v. *Commissioner*, 423 F. 2d 494 (C.A. 9), taxpayer's petition for certiorari pending, No. 157, this Term, in which the government has prevailed under a *Corn Products* rationale in the last seven years. Moreover, as we show in our brief in opposition in *Hollywood Baseball*, the *Corn Products* rationale was not essential to the result reached in that case.

Fiber wanted (Pet. (No. 415) App. 29) to "continue as the raw material supplier." Waterman, Largen wanted (*ibid.*) "to become sales agent for the mill's entire production." In No. 416, Steadman furnished permanent capital to a financially troubled client corporation (Pet. (No. 416) App. 14) "to protect his position as general counsel for Richards Music and the earnings necessarily flowing from such position." The notion that these diverse business motivations rendered the entire investment in Elmvale-Laurens and Steadman's investment in Richards Music non-capital in nature is completely foreign to the tax statute. Yet, this notion underlies the holdings below.

To avoid the rules that are applicable to capital stock, respondents argue (Br. (No. 415) 8–9; Br. (No. 416) 10–12) that they should be treated as having acquired other assets under the step transaction doctrine. But that doctrine may properly be invoked only when the stock is acquired merely as an interim step in obtaining another asset. Thus, in *Western Wine & Liquor Co.* v *Commissioner*, 18 T.C. 1090, and in *Kimbell-Diamond Milling Co.* v *Commissioner*, 14 T.C. 74, affirmed *per curiam*, 187 F. 2d 718, certiorari denied, 342 U.S. 827, the taxpayers sought specific assets owned by the corporations whose stock was acquired and had no interest in the continuance of the corporate ventures. They promptly extracted the desired assets and discarded the stock. In contrast, Waterman, Largen and Steadman were interested only in the continuing existence of Elmvale-Laurens and Richards Music, respectively, and in the latters' continuing success. Respondents did not acquire their

stock as a transient measure or an interim step in the acquisition of other assets, but rather to keep it for the long term. Their assertion that the step transaction doctrine applies in these circumstances to transcend their ownership of capital stock represents a clear perversion of that doctrine.

It thus makes no difference that Waterman, Largen might have received ordinary, rather than capital, treatment if it had sold a right to future brokerage commissions (Br. (No. 416) 8-9), or that Steadman might have received such treatment upon a sale of the "thing" he says he bought (Br. (No. 416) 11)—"a continuing source of legal fees." Since respondents purchased nothing less than full ownership rights in corporations, and since they cannot be treated as having acquired other assets under the step transaction doctrine, the transactions here in question must be tested and taxed in accordance with the rules applicable to capital stock.[4]

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[3] This is particularly clear from the evidence in *Waterman, Largen*. Carey Kinney insisted (Pet. (No. 415) App. 29-30) that respondent "should have a substantial financial interest in the mill" so that the relationship would be "in the nature of a joint venture."

[4] Steadman argues (Br. (No. 416) 7) that the government's position is inconsistent with Treas. Reg. 1.1221-1, which provides that the holding period of an asset is not to be taken into account in determining its character. But the length of the holding period of stock is relevant only in determining whether the taxpayer should be treated as having acquired stock, or whether the stock acquisition should be considered an interim step, so that the taxpayer is deemed to have acquired an underlying asset. Once it is determined *what* asset the taxpayer is to be treated as having acquired, that asset is to be *characterized*, in accordance with the regulations, without regard to its holding period.

3. Only infrequently does the government find itself constrained to seek certiorari in tax cases which raise no conflict with a decision of another court of appeals. These petitions are unusual ones, predicated on what the government regards as an urgent need for reversal of the decisions below because the questions of statutory interpretation and application involved are basic and far reaching. Respondents assert (Br. (No. 415) 12; Br. (No. 416) 9–10) that, for this purpose, Congress, rather than this Court, is the appropriate forum. However, a congressional amendment to the Code is not needed to require capital treatment in these cases. It is respondents, not the government, that ask that the present capital asset provision be scrapped.

Respondents tell us (Br. (No. 415) 6; Br. (No. 416) 8, 10) that the *Corn Products* principle is clear-cut and easy to apply. The commentators say the contrary. (See Pet. (No. 415) 15–16 & n. 6.) Respondents tell us (Br. (No. 415) 8–10; Br. (No. 416) 8) that review by this Court would serve no purpose, that this Court's consideration of the issue would give rise to as many problems as it would solve. But the question is clearly a recurring one on which this Court's guidance would be useful to the lower courts. And, a reaffirmation by this Court of the basic principle that the step transaction doctrine may be applied only where one asset is acquired as an interim step in obtaining another would, in and of itself, resolve most of the problems raised by the *Corn Products* doctrine.

The lower courts have had 15 years of experience under *Corn Products*. During that time, they have

misunderstood its holding and, more recently, culminating in these cases, have expanded that holding beyond recognition. The point has now been reached where, absent elucidation by this Court, there is no longer a realistic prospect that *Corn Products* will be properly interpreted in the courts below. We urge, therefore, that the Court hear these cases and clarify the law.

Respectfully submitted.

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